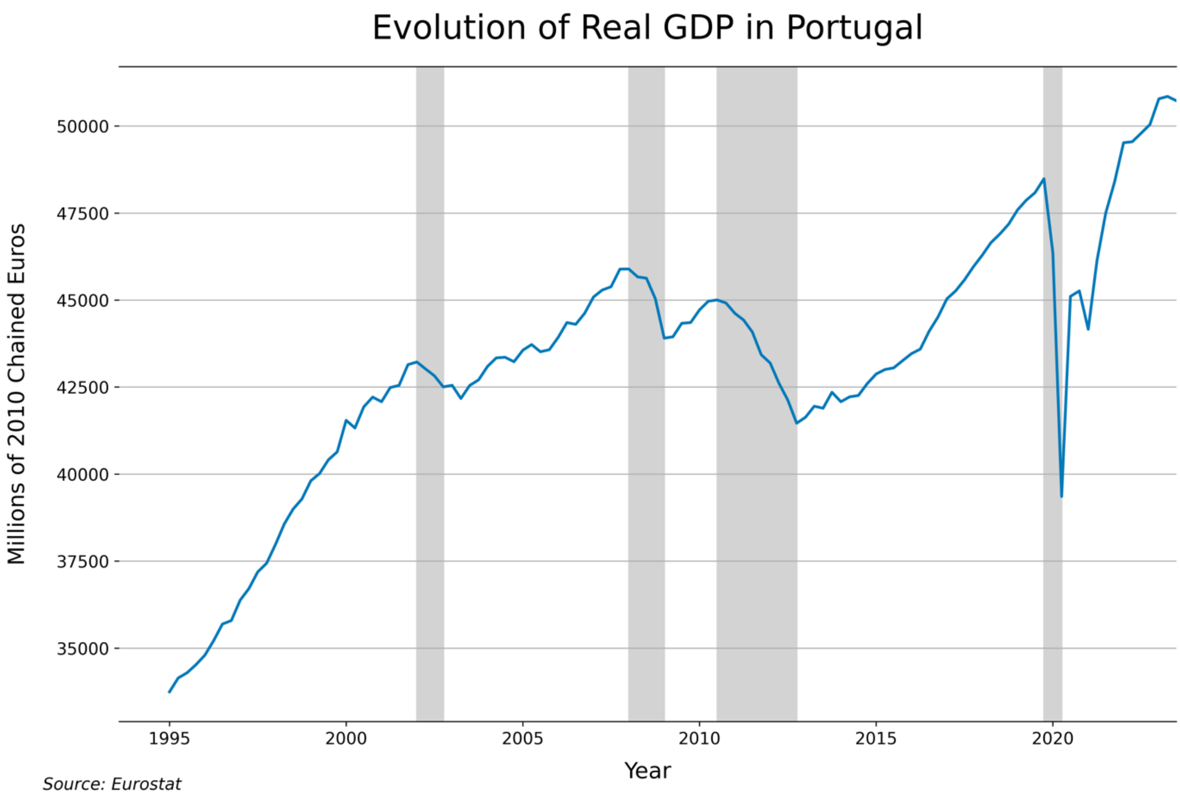
To: Minister of Finance of Portugal

Subject: State of the Domestic Economy

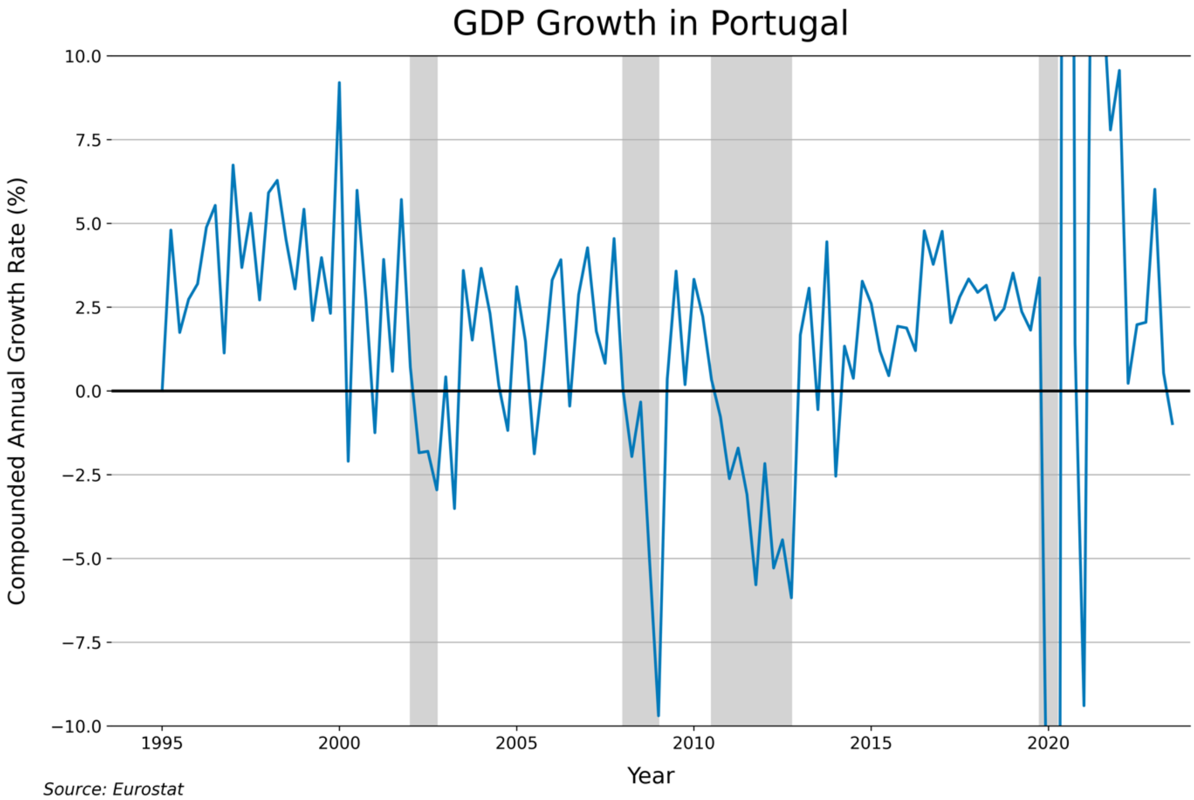
Executive Summary: Over the past 30 years, Portugal has seen slow growth punctuated by severe recessions, suggesting no real progress in economic convergence. Unemployment, which posed significant challenges during the 2010s, has now recovered and stabilized. Short-term inflationary pressures have been controlled through ECB intervention. However, concerns remain that the impact of monetary policy may lead Portugal into a new recession.

This economic analysis starts in 1995 for historical reasons, such as data unreliability prior to 1974 under the dictatorial regime. Moreover, the 1970s and 1980s were characterised by severe macroeconomic imbalances, prompting two IMF interventions. Incentives to adopt market mechanisms and pursue macroeconomic stability only emerged upon joining the European Economic Community in 1986 and committing to the monetary union. Compliance with the convergence criteria began in the mid-1990s, laying a stable foundation for economic analysis within the European economic framework. For the short run, analysis starts in 2020. Economic indicators in this period are volatile due to external shocks and government policies, potentially masking underlying trends.

Real Gross Domestic Product: Given the negligible population growth since 1995, changes in real GDP are fully attributed to capital accumulation and productivity growth.



In the long run, the economy is characterized by periods of slow growth (below 2%), punctuated by severe recessions. After an initial period of steady growth and real convergence with Eurozone counterparts, the first recession occurred in 2002 - immediately after the introduction of the Euro. The following period was one of shaky growth and accumulation of many macro imbalances, primarily stemming from increased indebtedness. This placed the country in a position of vulnerability for the financial crisis of 2008 and Eurozone crisis of the 2010s, forcing it to request a bailout from the IMF. It wasn't until 2017 that the country managed to recover the levels of GDP observed before the financial crisis. Had the economy sustained the average growth rate from 1995 to 2002 (3.6%), the current GDP level would have been achieved in 2007.

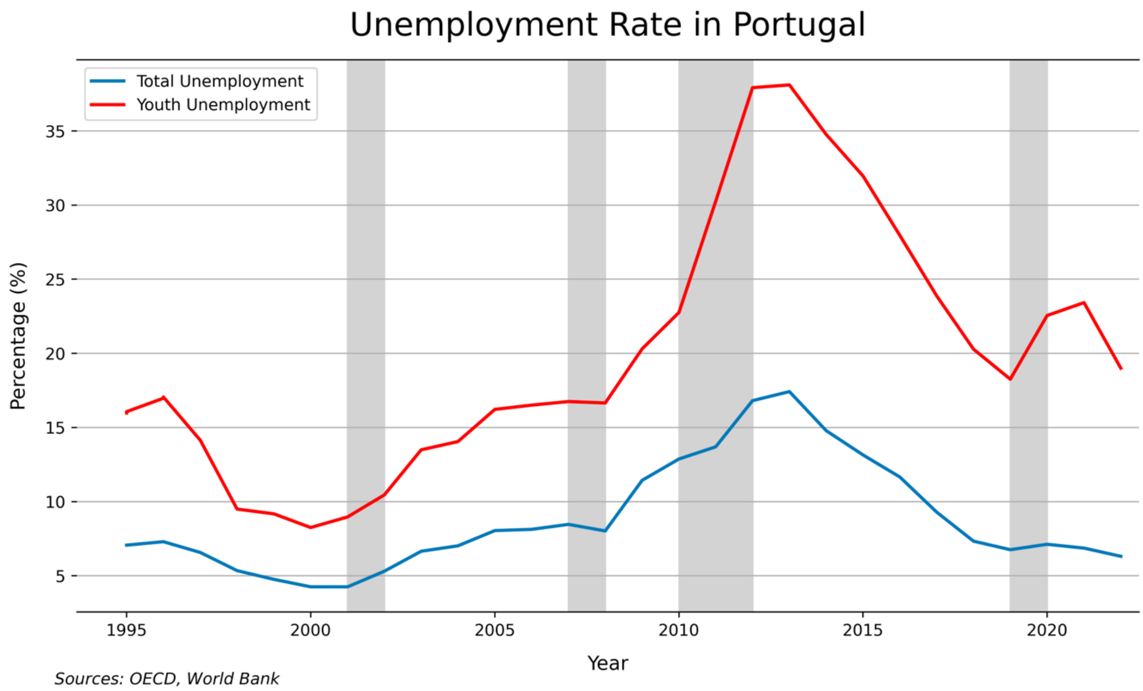


Source: Eurostat

Technical Note: Y-axis limits are set between -10% and 10% to enhance clarity of visualization of GDP growth trends. This adjustment mitigates the distortion caused by the extraordinary COVID-related fluctuations, of magnitude up to 60%.

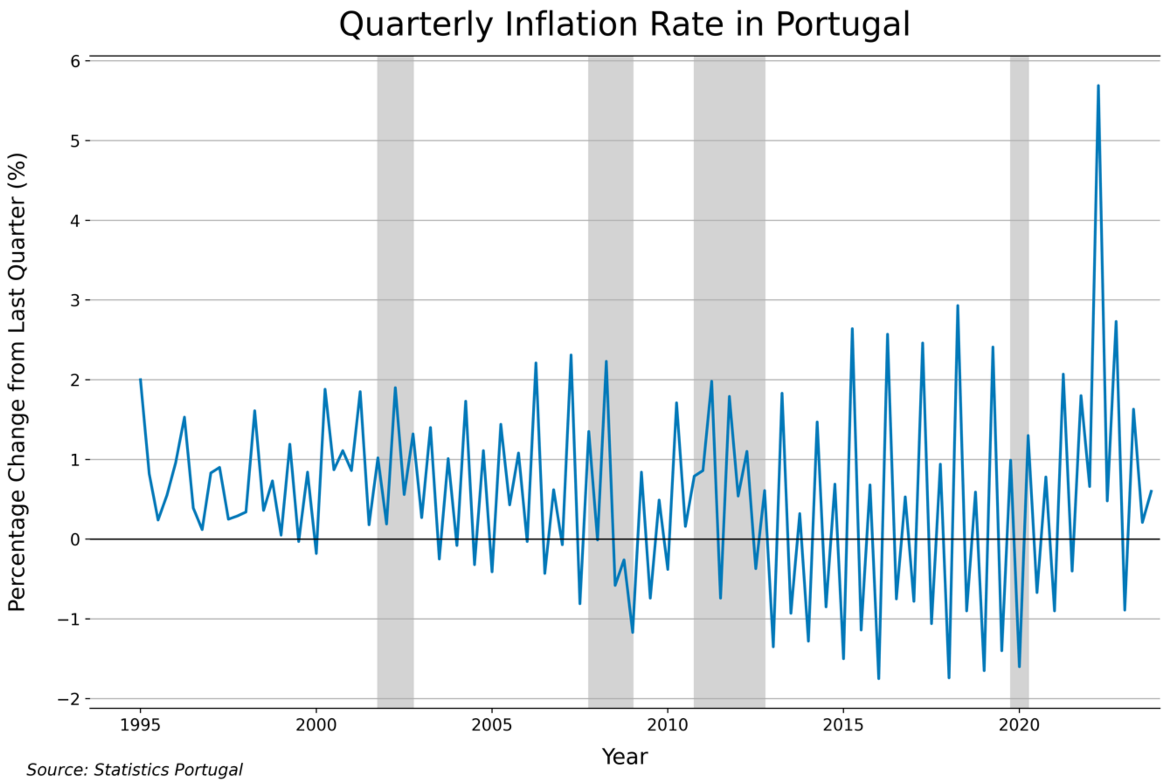
In the short term, the Covid pandemic delivered a heavy blow to the economy. However, the rebound was almost immediate and followed by the strongest growth rates in 20 years. Currently, the economy is slowing down again, with the last quarter being one of negative growth.

Unemployment: The first decade was one of mild fluctuations, with the total unemployment rate hovering around 5%. After that, influenced by the macroeconomic imbalances and the two recessions that hit the country, unemployment rose rapidly to a maximum of 17% in 2013. Since then, this indicator has consistently decreased. Youth unemployment has been more pronounced and volatile. It was greatly impacted by the Eurozone crisis, where it rose to almost 40%. Curiously, there were two occasions where unemployment rose despite economic growth, contradicting Okun's law. This observation suggests underlying structural issues impacting the economy beyond typical cyclical patterns.

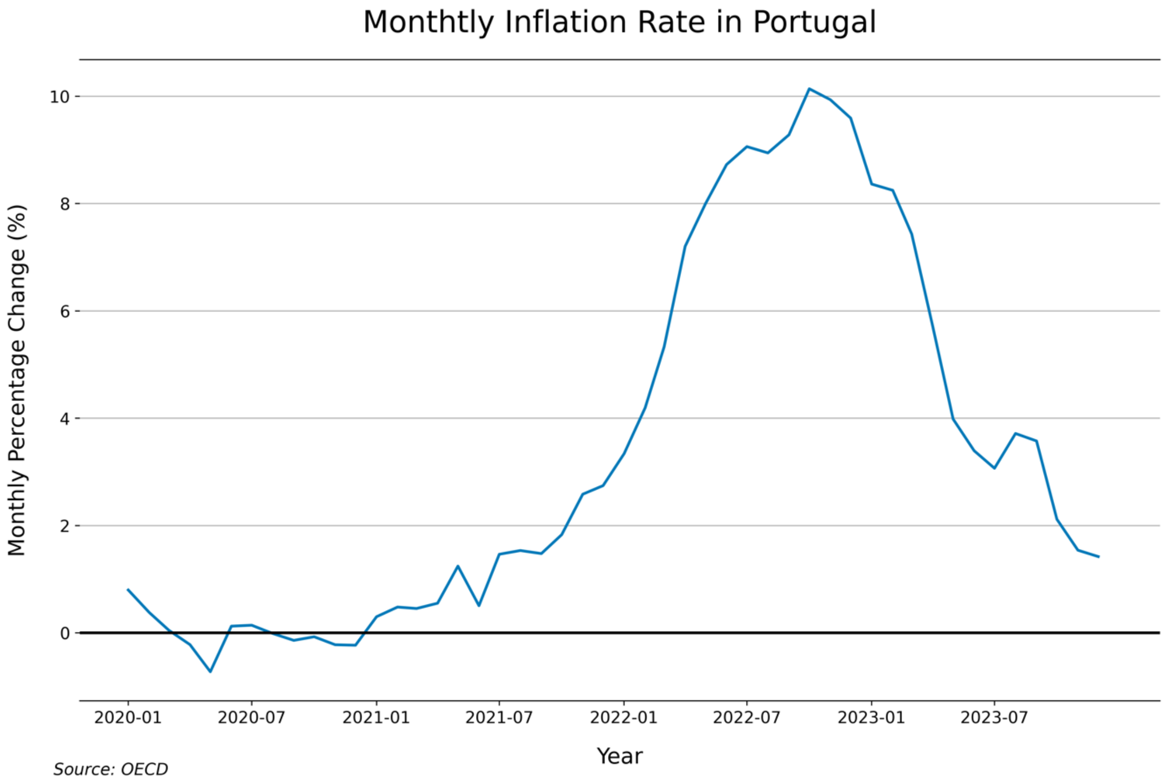


The pandemic didn’t take much of a toll on total unemployment rate. Rather, it merely continued on a slower downward trend, recovering to pre-financial crisis levels. Youth unemployment was more severely affected, increasing by 5% but also recovering quickly. Nevertheless, it still hasn't fully returned to 2007 levels.

Inflation: Prices have risen moderately at a rate of 2%, in line with the ECB's target. The inflation rate remained somewhat stable during the first decade, with steady price increases. However, deeper variations occur afterwards, with both bigger price increases and decreases.



The Covid pandemic triggered a short deflationary recession, marked by large negative shocks, with aggregate demand being more impacted than supply. After the slow reopening in 2021, consumers rapidly resumed their spending, backed by lockdown-period savings. Government spending was also increased to support the economy. Even though there were still strong constraints in supply chains, the positive demand shock outweighed the negative supply-side shock. This combination led to an influx of liquidity into the economy, resulting in inflationary pressures.



The steep rise in prices starting in 2022 is caused by a regional issue in the EU: the Russian invasion of Ukraine causing scarcity in energy markets. Rising production costs in most industries were primarily passed through to output prices. While initially disruptive, the negative supply shock later triggered a positive demand shock, with both factors exerting roughly equal but opposing pressure. Because of pent-up demand, extra savings and expansionary fiscal policy aimed at supporting energy purchases, consumers kept spending despite higher prices.

In late 2022, the ECB intervened to counter inflationary pressures by gradually lifting interest rates from 0.5% to 4%. Prices continued to rise, albeit at lower rates, meaning that the magnitude of the positive demand shock is being slowly but successfully offset. Additionally, lower energy prices and the easing of supply bottlenecks further reduced inflation. The goal to stabilize inflation at 2% by 2025 has already been reached. However, prolonged effects of monetary policy could risk pushing the economy into a recession.

Data Sources:

Eurostat: Real GDP, Quarterly

OECD: Total Unemployment Rate, Yearly

World Bank: Youth Unemployment Rate, Yearly

Statistics Portugal: Inflation Rate, Quarterly

OECD: Inflation Rate, Monthly

Code Book:

GitHub: PP440-WT-Memo