April 6th, 2022

Executive Summary

The **invasion of Ukraine by Russia** on February 24, 2022 was a geopolitical event of historic dimensions that creates a strong disturbance to the international order and, also, to the world economy. European economies, including Portugal, were returning to pre-pandemic levels of activity, in a process of normalization that was expected to occur throughout the year. The effects of the economic policies used by most developed countries during the last two years were manifested in several dimensions, namely in the rise in **energy prices**, in **inflation** and in a perspective of rising **interest rates**, faster in the United States than in the eurozone. This relative short-term predictability has disappeared, and economic uncertainty has increased significantly in the last weeks. The severity of the **economic and financial sanctions** applied to Russia by the US, the European Union and other NATO countries (among others) created additional uncertainty.

Therefore, the **Portuguese economy** might have **grown 0.2%** in the **first quarter of 2022 over the previous quarter (qoq)**, reaching a **GDP level of 98.8% of the fourth quarter of 2019**, the last without the effect of the pandemic. This estimate is wrapped in enormous uncertainty due to the erratic behaviour in January, February and March of the available high-frequency indicators. External trade deflators, heavily influenced by energy prices, allow for either expansion or contraction of economic activity. A certain weakness at the end of March suggests that the second quarter may be lower than the fourth quarter of last year. However, the shock seems to be much smaller compared to that observed in the various quarters of the pandemic's lockdowns.

In the **central scenario**, the estimated growth of the Portuguese economy is **4.0% in 2022**, a downward revision of 0.3 percentage points from the previous figure, but with a **wide forecasting interval** comprised **between 3% and 5%**. The economic shock may have an annualized cost between 0.5 and 2.0 percentage points, considering the effects on energy prices and the external balance. However, EU funds from the Recovery and Resilience Plan (PRR), which can be used throughout the current year given the low execution in 2021, should mitigate that downward revision, limiting the impact of the potential shock on Portuguese GDP growth.

The **inflation rate** in Portugal reached 5.5% in March, with a core rate, which excludes energy and unprocessed foods, of 3.8%, slightly above the eurozone figure (3.2%). Thus, the NECEP forecast is that inflation will be **between 3% and 7% in 2022**, with a **midpoint of 5%**. This is a strong upward revision from the central scenario of 2.0% indicated in the last quarterly newsletter for 2022.

The materialization of the geopolitical risks in Ukraine may increase the need for investment in defence to protect the EU countries from the Russian threat. Additionally, this context would lead the American and European central banks to moderate the normalization of monetary policy. However, this is not happening due to well-founded fears that inflation has components, not only transitory, but also permanent. Thus, NECEP anticipates that the ECB will find it difficult to reduce the **eurozone inflation** in the medium term, with a central point around **2.5% in the time horizon of 2024**.

The **Budgetary Plan for 2022** that the XXIII Constitutional Government will approve is not yet known, but everything indicates that the deficit targets will be maintained, as indicated in the recent *Stability Programme 2022-2006*. However, the macroeconomic scenario is now significantly different compared to last October, which will force difficult decisions to be taken, and some socio-union conflict is to be expected following the inflation pressures. Due to the foreseeable alignment of interest rates with inflation in the medium and long term, debt service costs are expected to rise significantly, and external balances may be subject to great pressure, although they will benefit from capital transfers from the Union European.

The evolution of the severity of economic and financial sanctions against Russia will be an essential topic in the coming months and years. In this context, the Portuguese Government will tend to align its position with the leadership of the US and Germany as far as the foreign affairs are concerned.

Forecasts from Católica Lisbon Forecasting Lab – NECEP

Region	Indicator	2021 Q4 a)	2022 Q1	2021	2022 scenarios (% change)		
					Downside	Central	Upside
Portugal	GDP (% change on previous quarter)	1.7	0.2	-	-	-	-
	GDP (year on year/annual % change)	5.9	9.3	4.9	3.0	4.0	5.0
	Unemployment rate (%)	6.3	6.0	6.6	6.2	6.1	6.0
	Consumer prices (annual % change)	1.3 b)	2.2 b)	1.3	7.0	5.0	3.0
Euro Area	GDP (% change on previous quarter)	0.3	-0.2	-	-	-	-
	GDP (year on year/annual % change)	4.6	4.6	5.3	2.7	3.7	4.7

a) Official values (Statistics Portugal – INE/Eurostat); b) Values at the end of the quarter.

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