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Portugal: Beyond the political mist

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Higher uncertainty resulting from Portugal's political picture on the aftermath of October's general elections has reignited some fears regarding the country's economic and financial health. In this note we recall developments that, in our opinion, provide evidence of economic resilience, but also major sources of risk and uncertainty. The improvements noticed at a macro level, reduced imbalances, stronger private sector and better equipped businesses, as well as the favourable terms of trade evolution and the shield given by the European Central Bank aggressive monetary policy, are some of the factors that justify our scenario of economic growth consolidation. Regarding the fiscal situation, it should be emphasized the strong consolidation effort of the past years (second largest structural adjustment within EMU, less 6.4 p.p. from 2010-2015) and the structural reforms implemented that are non-reversible, such as the more efficient tax collection system, enlarged tax-base and leaner public administration. It is also important to acknowledge the Socialist Party's (PS) commitment to the European Union rules, pledging to keep the fiscal consolidation effort, although at a slower pace. Finally, we recall that the outlook for a lower public debt ratio in 2015 is still holding and also the existence of a comfortable liquidity buffer, amounting to circa 2/3 of 2016 public financing needs[1]. In what concerns the risks, we highlight a possible disappointment with the global economic activity, particularly in EMU countries, besides the risk of protracted political uncertainty internally, which could damage confidence and impact negatively on economic growth.

Indeed, negative risks to the present outlook cannot be disregarded as the economic growth trend is low and important vulnerabilities persist. This was already reflected in the recently released 3rd quarter GDP flash estimate, which has been below expectations, showing that the economy stabilized on a quarterly basis while y/y growth decelerated to 1.4%. Against this background we maintain our forecast of 1.6% annual increase of the GDP in 2015, but the probability of a downward revision has increased. Considering all the pros and cons, we are keeping our baseline scenario, while expecting for additional developments and further details concerning the proposals of the (expected) next Executive.

Portugal - Macroeconomic scenario

	2014	BPI September 2015			Bank of Portugal Nov 2015			European Commission Nov 2015			OECD Nov 2015		
		2015F	2016F	2017F	2015F	2016F	2017F	2015P	2016P	2017P	2015P	2016P	2017P
Real GDP	**0.9**	**1.6**	**1.8**	**1.9**	**1.7**	**1.9**	**2.0**	**1.7**	**1.7**	**1.8**	**1.7**	**1.6**	**1.5**
Private Consumption	2.1	2.6	1.6	1.2	2.6	1.7	1.7	2.6	1.7	1.8	2.5	1.6	1.5
Public Consumption	-0.3	0.6	0.3	0.5	0.1	0.2	0.0	0.5	0.3	0.4	0.5	0.5	0.4
Investment	5.2	4.2	0.5	4.0	6.2	4.4	6.0	5.6	3.9	5.5	6.0	3.0	2.6
Exports	3.4	6.0	4.3	4.5	6.3	6.0	6.4	5.3	4.8	5.3	6.8	5.9	5.5
Imports	6.4	8.0	2.8	3.5	7.9	5.5	6.5	6.7	5.3	6.1	9.2	6.0	5.4
Domestic demand	2.1	2.5	1.2	1.5	1.6	1.6	1.6	2.7	1.8	2.1	2.7	1.6	1.5
Foreign demand	-1.2	-0.9	0.6	0.4	0.1	0.3	0.4	-1.0	-0.1	-0.3	-1.0	0.0	0.0
Inflation rate (annual average)	-0.3	0.5	1.0	1.5	0.5	1.2	1.3	0.5	1.1	1.3	0.5	0.7	1.0
Unemployment rate	13.9	12.6	12.2	12.5	-	-	-	12.6	11.7	10.8	12.3	11.3	10.6
Budget balance (% GDP)	-7.2	-2.9	-2.8	-2.7	-	-	-	-3.0	-2.9	-2.5	-3.0	-2.8	-2.6
Public debt (% GDP)	130.2	128.8	127.1	124.8	-	-	-	128.2	124.7	121.3	128.2	127.9	127.4
Current+Capital account (% GDP)	3.1	2.0	1.8	1.8	2.3	3.2	3.4	1.9	1.9	1.7	1.9	1.8	1.4

Source: Bank Portugal, Ministry of Finance, European Commission, BPI, OECD.

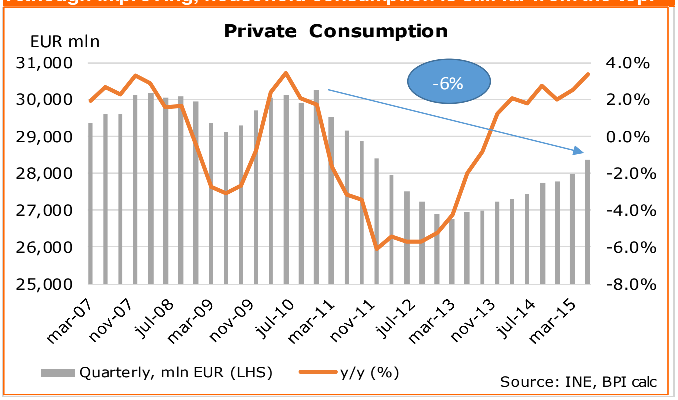
Economic activity presents a steady pattern: In 2014 the Portuguese economy returned to growth by posting a GDP growth rate of 0.9%, this following three years of contractions, with domestic demand recovering and resuming its position as the main driver of growth. This pattern was also apparent during the first half of 2015: GDP gained 1.5% from the 1H14, and domestic demand was once again the main engine of growth whereas net exports kept a negative contribute.

[1] When excluding revolving short term TBills, which we admit constant at the present bound, circa 13.5 bln euros. See note on the subject

The recovery of the domestic demand needs to be seen in the context of the abrupt economic contraction during the years of external assistance and the tough fiscal adjustment (see pictures below). Indeed, during the period from 2010 to 2014, private consumption and investment fell circa 16%, with household consumption retreating 10% (considering annual figures) and investment dropping more than 30%. Observing the evolution since the minimum, private consumption keeps more than 6% below the top (seen in the last quarter 2010) whereas GFCF is recovering, although much slowly. Going forward, we believe that household consumption will continue to recover, stimulated by the expected increase in disposable incomes. However, there is some uncertainty regarding the evolution of the labour market. Improvements in the job market have been losing momentum and it is possible that the unemployment rate stabilizes at double-digit levels. Moreover, the **probability that this risks materialize is higher in the current circumstances, given that political uncertainty may have an impact on business confidence.**

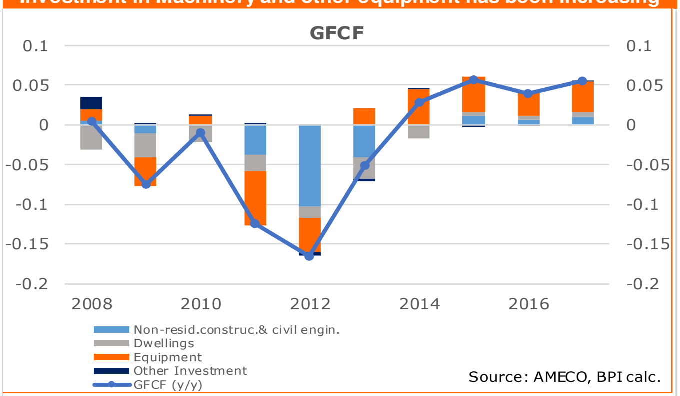
It is also uncertain the effect of the present situation in GFCF evolution. Indeed, in the last couple of quarters we assisted to a gradual recovery of investment in machinery and equipment as well as to a stabilization of investment in construction, an important step after several years of correction (GFCF in construction has been falling since 2000; in 2014 it reached less than half the construction investment 15 years ago, when measured in volume). It is still unclear if the present situation will have any damaging impact on business investment decisions, which have been gradually improving from very low levels. **As far as capex is concerned, this fragile environment is evident in the preliminary report for the 3dr quarter 2015 GDP: which points to the fall in fixed capital formation as one of the major factors behind the disappointing GDP outcome.**

Although improving, household consumption is still far from the top.



Source: INE, BPI calc

Investment in Machinery and other equipment has been increasing



Source: AMECO, BPI calc.

Exports demonstrate a remarkable trend: In the last couple of years, the tradable activities have been gaining weight in the Portuguese economy. At the macro level, the result has been a steady increase of the economy’s degree of openness and of the exports to GDP ratio (which reached over 40%). In this framework, the external market share gains, and the notable performance of goods and services exports when compared to European peers, suggest that behind these positive developments, there were gains in price and non-price competitiveness factors, that should offer resilience to Portuguese exports in case of negative external shocks.

In 2014 exports of goods and services decelerated mostly due to temporary effects related to the Sines oil refinery shutdown. However, it the first half of 2015, goods and services sales abroad increased 7.2% in volume from year ago levels. Several other metrics demonstrate the excellent performance of Portuguese exports, as it can be clear in the charts and tables below. Besides the diversification effort, both in terms of products sold abroad and export partners, it is also remarkable the strength of the movement, within a context of modest external growth: in the period Jan-Sept goods’ exports (current prices) increased 4.9%; **exports increased**

Exports of goods, 2015 January - September

10^6 euros	2014	weight	2015	weight	yoy	contribute
Industrial goods	12,117	34.0%	12,526	33.5%	3.4%	1.1%
Consumption goods	7,198	20.2%	7,499	20.0%	4.2%	0.8%
Material of transportation	5,346	15.0%	5,881	15.7%	10.0%	1.5%
Capital goods	4,613	12.9%	4,797	12.8%	4.0%	0.5%
Fuel	2,755	7.7%	2,885	7.7%	4.7%	0.4%
Foods and beverages	3,591	10.1%	3,778	10.1%	5.2%	0.5%
Other	38	0.1%	37	0.1%	-2.5%	0.0%
Total	**35,657**		**37,402**		**4.9%**	
Excluding fuels	32,902	92%	34,518	92%	4.9%	4.5%

Source: INE, BPI calc.

Main Portuguese export destinations - January to September

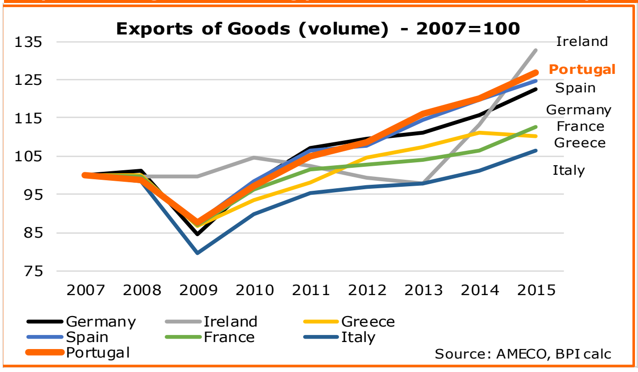
10^6 euros	2014	weight	2015	weight	yoy	contribute
Intra EU	25,484	71.5%	27,185	72.7%	6.7%	4.8%
Spain	8,438	23.7%	9,365	25.0%	11.0%	2.6%
Germany	4,291	12.0%	4,492	12.0%	4.7%	0.6%
France	4,265	12.0%	4,489	12.0%	5.3%	0.6%
United Kingdom	2,155	14.3%	2,465	6.6%	14.3%	2.1%
Netherland	1,436	4.0%	1,498	4.0%	4.3%	0.2%
Italy	1,117	3.1%	1,160	3.1%	3.9%	0.1%
Benelux	992	2.8%	922	2.5%	-7.0%	-0.2%
Others Intra EU	2,789	-0.5%	2,794	7.5%	0.2%	0.0%
Extra EU	10,174	28.5%	10,217	27.3%	0.4%	0.1%
US	1,529	4.3%	1,967	5.3%	28.6%	1.2%
Angola	2,232	6.3%	1,590	4.3%	-28.7%	-1.8%
China	593	1.7%	646	1.7%	8.9%	0.1%
Morocco	437	1.2%	523	1.4%	19.7%	0.2%
Brazil	453	1.3%	425	1.1%	-6.2%	-0.1%
Algeria	458	1.3%	421	1.1%	-8.1%	-0.1%
Switzerland	320	0.9%	348	0.9%	8.5%	0.1%
Canada	196	0.6%	283	0.8%	44.4%	0.2%
Mozambique	226	0.6%	266	0.7%	17.9%	0.1%
Turkey	310	0.9%	251	0.7%	-19.1%	-0.2%
Gibraltar	202	0.6%	174	0.5%	-13.8%	-0.1%
Others Extra EU	4,948	13.9%	5,464	14.6%	10.4%	1.4%
Total	**35,657**		**37,402**		**4.9%**	
Total excluding Angola	**33,426**		**35,812**		**7.1%**	

Source: INE, calc. BPI

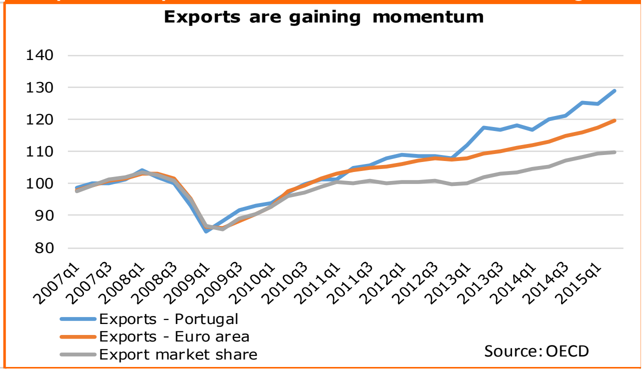
7.1% excluding goods sold to Angola (that declined almost 30%), which is quite remarkable. Destinations such as the UK, US or Canada have seen the highest gains, but of course exports to Spain were one of the best performers, adding 2.6 p.p. to the accumulated growth in the period. Finally, this encouraging performance can also be seen at the product level, demonstrating that it is wrong to attribute the positive behaviour of exports to the increased capacity of the GALP fuel refinery. Indeed, the group of products classified as vehicles and accessories, industrial and consumption goods were the best performers. Fuels accounted for circa 7.7% of exports in the period but added only 0.4 p.p. to total exports growth.

Finally, it is worth to emphasize the good performance vis-à-vis European peers and the gains in market share: according to OECD data, market share increased 9% since the end of 2013.

Exports: Portugal has a leading position, close to Ireland and Spain



Exports: over performance vis-a-vis EMU and market share gain



Imports of goods

A deeper look into imports data over the same period confirms that the favourable evolution of the terms of trade had a positive impact on the external accounts, especially as a result of lower oil prices. Indeed, oil is the most important primary energy source and the energy intensity degree is still high. Hence, the fuel import bill assumes considerable importance: back in 2012, energy imports accounted for 7% of GDP; this proportion has declined to an expected 4.6% of GDP in 2015, despite the increase in imports related with the oil refining activity. In fact, considering current prices, imports increased only 2.8% in the period January-September (see table).

Import of goods, 2015 Jan- September

10^6 euros	2014	weight	2015	weight	yoy	contribute
Industrial goods	12,571	28.7%	13,162	29.2%	4.7%	1.4%
Consumption goods	6,281	14.3%	6,936	15.4%	10.4%	1.5%
Material of transportation	5,420	12.4%	6,372	14.2%	17.5%	2.2%
Capital goods	6,116	14.0%	6,386	14.2%	4.4%	0.6%
Fuel	7,685	17.6%	6,164	13.7%	-19.8%	-3.5%
Foods and beverages	5,700	13.0%	5,993	13.3%	5.1%	0.7%
Other	7	0.0%	7	0.0%	13.8%	0.0%
Total	**43,780**		**45,021**		**2.8%**	
Excluding fuels	36,095	82%	38,857	86%	7.7%	6.3%

Source: INE, BPI calc.

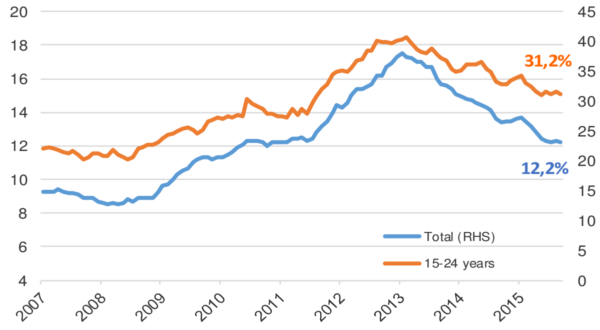
On the other hand, if we exclude fuel imports, we can clearly notice the impact of the domestic demand recovery on imports: imports excluding fuels jumped 7.7% from year ago levels while consumption goods and material of transportation added circa 3.7 p.p. to this result. The performance of industrial and capital goods – adding circa 2 p.p. to total growth – reflects mainly the recovery of Gross Capital Formation.

Overall, we expect the persistence of an external surplus namely at the current account level, considering also the gains obtained in the services balance (especially exports of Tourism and Transport services), whose surplus has been steadily increasing, providing some strength and resilience to the economy’s external profile. However, the risks have been increasing as the surge in private consumption continues to be directed to durable goods, with negative impact on the external accounts. Hence, the evolution of the external account in a two-three year horizon will chiefly depend on the economic policy stance: a looser fiscal policy could increase the probability of returning back to a negative external position, especially if stimuli is directed towards households at the upper bound of the income scale.

Labor market: Since the beginning of 2013 the labor market has been surprising positively. The unemployment rate declined from 17.5% in 1Q13 to 11.9% in 3Q15, employment increased (annually) for eight consecutive quarters and the number of unemployed has also declined at a considerable pace. Several programs to stimulate employment in the private sector (active labor market policies), and specifically the professional traineeships promoted by the employment centers, have contributed to job creation since 2013.
However, the more recent data shows some loss of momentum in this process. For instance, total employment increased 1.6% on average in 2014 whereas the pace of expansion fell to 0.9% in the period Jan-Set 2015. Specifically in the 3Q15, the number of jobs created increased a meagre 0.2% y/y. Additionally, the quarterly unemployment rate has been stable for the last two quarters at 11.9%. Considering this framework, we forecast a more moderate pace of recovery in the labor market going forward, with the average unemployment rate falling to 12.6% in 2015 and 12.2% in 2016.

Unemployment Rate - monthly figures suggest stabilization at a high level

(% of active population aged between 15-74 years)

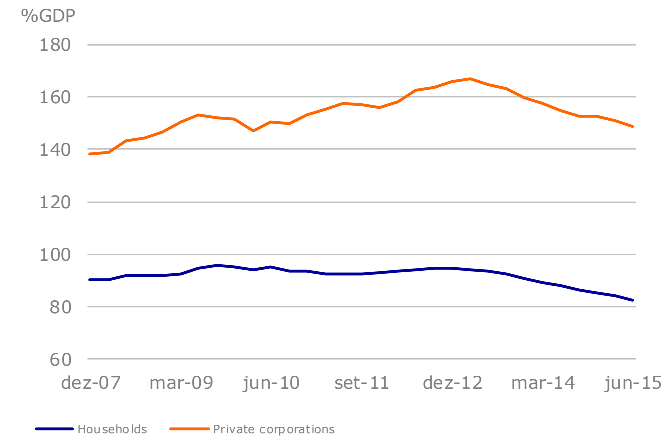


Source: INE; seasonality adjusted

Inflation rate: Annual inflation stood at -0.3% in 2014, mainly due to receding energy prices, although fragile domestic demand and efforts aimed at increasing competitiveness are also likely to have played an important role. For 2015, our forecast calls for inflation to reach 0.5% by the year's end, with low commodity costs and still weak domestic demand remaining the major restrictors of prices growth.

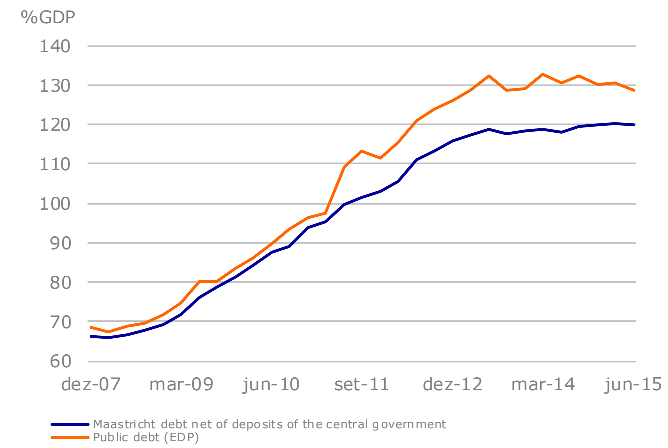
Indebtedness levels: Deleveraging has clearly advanced in the last couple of years, with the debt levels falling considerably in the private sector. Among private non-financial companies, the debt level fell from its peak of 167% of GDP in March 2013 to 149% (non-consolidated figures) in June 2015; and among families debt fell from 96% of GDP in Sep 2009 to 82.5% in last June. Even so, indebtedness remains high, mainly at the corporate level, which may continue to put a drag in investment going forward.

Indebtedness levels in the private sector



Source: Banco de Portugal

Indebtedness levels in the public sector sector

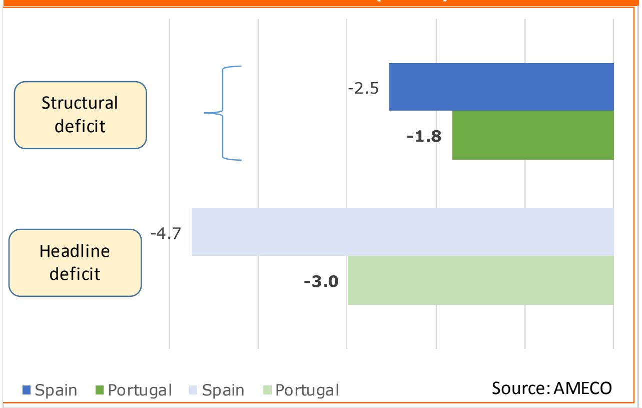


Source: Banco de Portugal

Public accounts: According to the National Statistics Office (INE), the final deficit for 2014 stood at -13 bln euros, after revisions that have been mainly due to the inclusion of 4.9 billion euros related to the capitalization of the Novo Banco (the bank that resulted from the Banco Espírito Santo, SA resolution in August 2014). This amount has been reclassified as capital expenditure according to a decision by the Eurostat. Excluding the impact of the Novo Banco recapitalization, the public balance stood at -4.4% of GDP, within the expected figures.

In the first half of 2015, on accrual basis, the general government recorded cumulative financing needs of about 4.1 billion euros (bln), equivalent to 4.7% of GDP. The adjusted balance, corrected from non-recurring effects (namely various capital increase operations in public companies), was a deficit of about 3.8 bln. Although having improved about 180 bln over the same period (also adjusted), the performance of public accounts demonstrates that there are some risks that the target of reaching a fiscal balance below the 3% threshold may not be achieved. Nevertheless, it is worth recalling that considering the average standard of budget execution the behaviour of government accounts in the second half of the year is usually more favourable; additionally, there is also some budget slack that can still be used.

Balance of General Government - 2015 (%GDP)



In the field of public accounts some important improvements have also been achieved that give fiscal policy some leeway at the moment. The reduction of public workers (see next table) has been one of the major development that give some room to act. Indeed, since 2005, when public employment reached the top, the number of public workers fell 12% at the Public Administration level, and 21% in state owned companies (SOEs, including the financial sector). In absolute terms, the number of public workers declined more than 100 k, having reached 712 k in June 2015, circa 16% of total employment.

Public Servants - By sector of the Public Administration

	Public Administration			
	Total	Central Government	Local and Regional Administration	Public Companies (1)
1996	639,044	500,535	138,509	
1999	716,418	566,548	149,870	
2005	747,880	578,407	169,473	
Dec-11	727,294	551,373	163,178	
Dec-12	699,480	529,844	157,324	72,855
Dec-13	674,338	509,520	153,072	57,986
Dec-14	655,820	497,020	148,078	57,488
Mar-15	656,618	498,940	147,753	57,273
Jun-15	654,600	497,133	147,579	57,686
from 2005 to Jun	**-93,280 -12%**	**-81,274 -14%**	**-21,894 -13%**	**-15,169 -21%**

Source: DGAEP, calc. BPI

(1) - Includes financial and non-financial companies not considered in the Public Administration aggregate; impacted by the several privatizations, resolution of Novo Banco, Banif during 2014.

Despite the uncertainty regarding fiscal policy, given the outcome of the recent legislative elections' results, the Socialist Party (that will probably lead the next Executive) has been pledging that the international compromises, in particular within the Eurozone, will be granted. Mr Centeno, who has been behind the macro and fiscal scenario of the Socialists, affirmed that fiscal consolidation is going to continue, although at a slower pace. In this framework, the stance of fiscal policy will probably be more expansionary going forward, and that presents some risks given the still high public debt level. However, we believe there is some leeway to act in order to keep both compromises – some electoral pledges and the external commitments.

Having said this, at present, there is not enough information to evaluate the fiscal policy of the next government. Up to now, it is only certain that PS is committed with ensuring that next January 2016 all extraordinary measures within the fiscal policy will not expire (in particular public sector wages would return to normal levels, without any reduction), which is seen as a careful stance. Further considerations will have to wait for the 2016 Budget, which will probably not be known until early 2016.

Finally we recall that these are key variables – the deficit and public debt - for international investors and rating agencies that have been issuing some warnings especially as far as the path of fiscal consolidation is concerned. These are important signals, suggesting that despite some recognized leeway due to the economic recovery path, stronger position on the real side of the economy and sounder fiscal and liquidity position, a precautionary and moderate stance should be assumed regarding fiscal policy. Indeed, there is no scope for a too relaxed stance.

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