The evolution of the Portuguese economy

While Portugal has gone through many economic difficulties, the country is bouncing back, writes ***João Miguel Lourenço****, Head of Equity Research, and* ***Leonor Canedo****, Head of Syndication and Sales, CaixaBI*

According to data released by the Portuguese Statistical Office INE, the Portuguese GDP registered YOY growth of 1.3 percent in the fourth quarter of 2015. This follows 1.4 percent growth in the previous quarter and 1.5 percent in Q2 2015. In relation to the previous quarter, GDP grew 0.2 percent in Q4 2015, up from 0.1 percent growth between July and September.

In 2015, the GDP growth rate was 1.5 percent, following growth of 0.9 percent in 2014 and a contraction of 1.1 percent in 2013. In the period from 2011 to 2013, Portugal's GDP fell by 6.9 percent in cumulative terms as a result of a significant contraction in domestic demand – with a cumulative decline of 15 percent in domestic demand between 2011 and 2013 – which was partially offset by an improvement in net external demand due to a significant rise in exports (+17.4 percent in the same period) and a reduction in imports (-7.4 percent in cumulative terms). The adjustment process of the Portuguese economy following the agreement made with the EU, ECB and IMF to implement the Economic and Financial Adjustment Programme, which was executed between May 2011 and May 2014, explains these variations.

In Q4 2015, net external demand made a negative contribution of 0.9 percentage points (referring to -0.7 percentage points in the previous quarter). On the other hand, domestic demand had a positive contribution of 2.1 percentage points to GDP growth, the same as in the third quarter. Private consumption registered YOY growth of 2.4 percent in Q4 2015, up from 2.3 percent in Q3 2015, at a time when expenditure on durable goods rose 7.7 percent after an identical increase in the previous quarter. Expenditure on non-durable goods and services saw a rise of two percent compared with 1.9 percent in the third quarter.

Investment registered a YOY increase of 2.4 percent in Q4 2015 (+2.4 percent in the previous quarter), with gross fixed capital formation falling 0.9 percent YOY from 2.0 percent in Q3 2015, due to the negative impact from the decline in the 'other machinery and equipment' component. Exports of goods and services were up 2.3 percent in the fourth quarter of 2015, compared with four percent in the third quarter. This was the result of increases of 2.2 percent in the export of goods and 2.7 percent in the export of services. However, the imports of goods and services rose 4.3 percent YOY, after a growth of 5.4 percent in the previous quarter. The imports of goods were up five percent (six percent in Q3 2015) while those of services increased 0.1 percent (+1.7 percent in the previous quarter).

Portugal's Finance Minister Mario Centeno. Portugal's economy has seen turbulent times, but has evolved recently

Consumer confidence improvements

The positive GDP performance over the last few quarters has reflected the economic trend that's currently associated with the Portuguese economy. Reducing the external imbalance of the country's economy was one of the priorities of Portugal's Economic and Financial Adjustment Programme, implemented between May 2011 and May 2014.

This meant rebalancing the current and capital accounts – with deficits of around 10 percent of GDP in the years leading up to 2010 – followed by a surplus of roughly 1.7 percent of GDP in 2015, the steady reduction of the government deficit – as well as the deleveraging of the private sector, including the financial sector – with the aim of lowering the economy's financing needs. This proved effective and since the fourth quarter of 2012, the balance of the Portuguese economy's financing capacity has been positive as a result of the decline in domestic demand (private and public consumption) and in imports, in conjunction with a higher savings rate.

Consumer prices in Portugal for March 2016 registered a year on year variation of +0.4 percent, compared with -0.2 percent in February 2015, with the most significant rise in services prices. The inflation rate in Portugal is higher than in the eurozone (+0.4 percent versus zero percent YOY in March) due not only to the fact that the fall in energy prices impacted the Portuguese economy less than the eurozone, but also to a bigger increase in the price of services.

According to INE data, the unemployment rate for the fourth quarter of 2015 stood at around 12.2 percent, down from 13.5 percent at the end of 2014, 16.2 percent at the end of 2013 and 15.5 percent at the end of 2012. Since reaching its peak of 17.5 percent in the first quarter of 2013, there has been a significant improvement in the unemployment rate at a time when economic activity has registered progress. INE data shows the budget deficit for 2015 was 4.4 percent of GDP, which corresponds to €7.9bn, incorporating the adjustments due to the resolution of Banif, with GDP rising to €179.4bn. It is estimated the budget deficit for 2016 will be 2.2 percent of GDP.

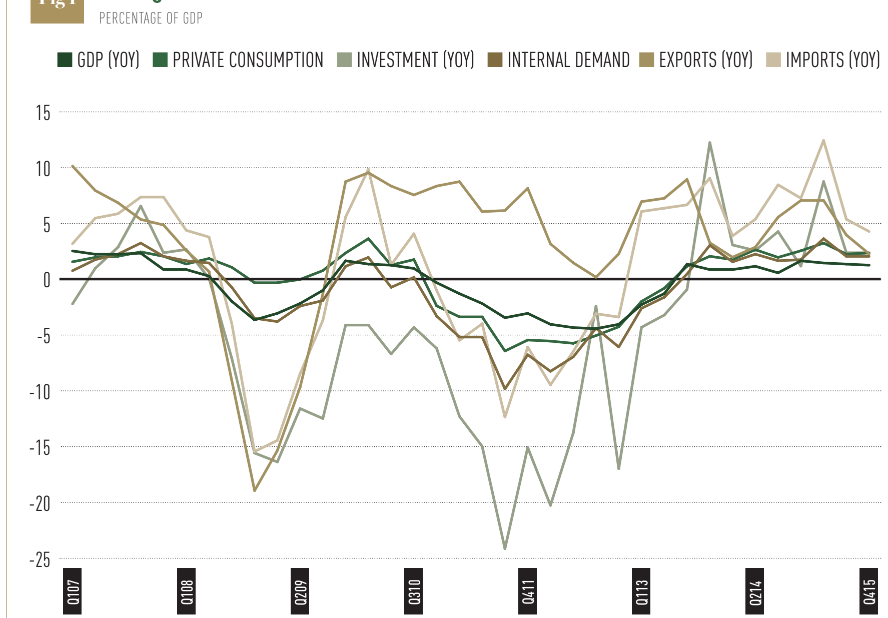
At the end of March, the Bank of Portugal updated its forecasts for the Portuguese economy in 2016 and 2017 released in the December 2015 Economic Bulletin (EB) and also presented estimates for 2018. It has lowered its estimate for GDP growth in 2016 by 0.2 percent, from 1.7 percent to 1.5 percent.

A downward revision has been made to both the contribution from domestic demand, which is now expected to rise to 1.4 percentage points (down from 2.4 percentage points in the previous EB), and to that of net external demand to GDP, now estimated at 0.6 percentage points (0.8 percentage points, according to the previous estimate).

As for domestic demand, private consumption is expected to register growth of 1.8 percent (as previously estimated), public consumption is expected to rise 1.1 percent (in relation to 0.3 percent forecast in the December EB) and investment should increase 0.7 percent (from the previous estimate of 4.1 percent). On the other hand, exports should grow 2.2 percent, while the growth rate for imports is now expected to stand at 2.1 percent (versus. 3.3 percent and 3.6 percent in the previous estimate).

Generally, the projections made by the central bank for the Portuguese economy indicate a continuation of moderate growth in the economic activity. In this context, the Bank of Portugal anticipates GDP growth of 1.7 percent in 2017 (1.8 percent according to the previous estimate) and 1.6 percent in 2018. Moreover, the balance of the current and capital accounts should remain positive in the coming years, with an expected figure of 2.3 percent for 2017 and 2018. This will allow the adjustment process of the external imbalance to continue, notably boosting the financing capacity of the Portuguese economy (*see Fig. 1*).

Fig 1 Portugal's debt and deficit



SOURCE: BLOOMBERG

Note: Figures post-Dec 15 are Bloomberg estimates

Overcoming challenges

Last year was an intense year in the financial markets – specifically the ECB´s quantitative easing programme – the instability in currencies markets, the black Monday in China, the threat of interest-rate increases in the US and the uncertainties due to the fall of oil price. It was a year of countless uncertainties and very much marked by the actions of central banks.

The ECB began the year with the asset purchase programme, mainly sovereign debt of €60bn per month up to September of 2016, with the goal of reaching an inflation level close to two percent. This measure was expected to benefit largely all European issues, but by the end of the year it proved to be insufficient and below expectations.

The Federal Reserve announced in December a historic rise of the interest rates by 25bp. Yet in the 11 previous months, speculation around this measure had produced significant volatility in both global financial and foreign exchange markets, especially emerging markets. The Central Bank of China was involved as well in some of the most significant market movements during the year. In May, the Central Bank of China was faced with declining economic indicators and projections pointing to a below target economic growth, cutting interest rates for the third time in six months.

Additionally, it reduced the banking sector reserve requirement ratio in order to stimulate credit and to promote growth. In August last year, it decided to devalue the yuan after last July's Chinese exports contraction, which reduced the external trade balance. This instability in the Chinese economy and markets led to a spike in volatility in the financial markets, as investors feared a sharp slowdown in the Chinese economy.

Geopolitical issues were a relevant factor during 2015 with rising tensions in various regions: the Russia/Ukraine conflict at the beginning of the year; the intensification of the conflicts in the Middle East and in North of Africa; the growing migrant crisis in Europe, and the terrorist attacks of the Islamic State in France in January and November.

After the peak in August, the volatility index registered a declining trend in the following months with markets anticipating more assertive actions from central banks to stimulate inflation and promote global economic growth. In Portugal, the year was marked by the instability caused by October´s elections. The former ruling coalition lost their majority in parliament and ended up being replaced by a Socialist-Party-led government with parliamentary support from left wing parties.

Moreover, the uncertainty in the Portuguese financial system dragged along, with the postponement of the sale process and increased capital requirements for Novo Banco that resulted in the transfer of approximately €2bn of Novo Banco's bonds held by institutional investors to Banco Espírito Santo (BES). The Banif restructuring process accelerated towards the end of the year, with a resolution and a forced sale of the 'good bank' to Santander. Notwithstanding, the Portuguese yield curve maintained the descending trajectory of the previous year.

The first few months of 2016 were very punishing for the Portuguese yield curve due to the negative effect of the new directive on bank resolution – the new regime of bail-in that came into force in 2016 – in which debt holders may have to be called to share the debt burden. An early example of this new directive's impact was the aforementioned transfer of Novo Banco´s five senior debt issues to BES – a decision that was announced on December 29 last year.

Portuguese debt was also under pressure, and with the threat of rating downgrades by Moody's, S&P and Fitch that – despite the news of a worsening in last year's general government deficit figures and the struggle for its 2016 budget approval – decided to postpone the decision.

Additionally, the possibility of the withdrawal of investment grade notation by DBRS, which would mean bonds issued by Portugal would not be accepted as collateral by the ECB for its loans to Portuguese banks and exclusion of the national debt from the ECB's asset purchase programme (which sustains the country's current low yield levels).

In March, after the ECB´s announcement of a new package of measures, markets reacted positively, with spreads tightening across the peripheral markets, including Portugal. Given the volatility in the financial markets throughout 2015 and the significantly decreasing liquidity in European secondary credit markets as a result of much stricter banking regulations – reducing banks' balance support to markets – a low interest rate environment and higher capital needs for banks with little incentive to assign capital to assets with capital consumption resulted in a decrease in new issue volume in 2015, when compared to 2014.

Nevertheless, markets have remained open and fairly firm for frequent domestic issuers and newcomers, as well as for private placements. ■

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