Europe Watch

Portugal

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Economic Analysis

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The economic recession could have eased at the beginning of 2013

GDP could fall by around -0.4% q/q in 1Q13

- **Larger than expected recession in 4Q12**

  Even though we anticipated it, the GDP fall of 4Q12 was much larger than projected, due to an improvement in domestic demand in 3Q12 attributed to temporary factors (mostly a rebound in investment as a result of aircraft purchase). In particular, GDP dropped by -1.8% q/q in Q4 (BBVA Research and Consensus: -1.0% q/q), driven by a sharp decline in domestic demand, both investment (-5.1% q/q after +0.5%) and private consumption (-2.1% q/q after remaining flat in 3Q12), while fiscal adjustments took their toll on government consumption (-1.1% q/q after -1.9% q/q). As a result, domestic demand drained -1.9pp to quarterly GDP growth (in spite of +0.9pp contribution of change inventories). On the external side, the intensification of the recession in the eurozone in Q4 along with the slowdown observed in emerging economies in late 2012 resulted in a strong fall in exports, that was larger than that observed in imports, reflected in a negative contribution of net export for the second quarter in a row (-0.3pp after -0.7pp in 3Q12).

- **Data available for the 1Q13 point to a less severe economic downturn**

  Hard data improved in January, offsetting the poor performance observed over 4Q12. They together with the better confidence data up to February are in line with our macroeconomic scenario that envisages a milder recession at the beginning of the year. However, we remain cautious about the economic outlook in the short-run, as there are also disappointing leading signs about the exports performance in coming months, thus raising doubts about the sustainability of the main support of economic activity in coming quarters.

  Regarding soft data, the economic sentiment indicator released by the European Commission rebounded slightly in February after a brief dip in January, somewhat expected after the strong increase in December. Although it remains at low levels (81.5; almost 2 standard deviations below its historical average of 101.6) and still reflects a recession, the January-February average improved clearly over 4Q12, reverting to the levels observed in early 2012, when the economic contraction was more moderate (around -0.1% q/q). The improvement in confidence was widespread across sectors.

- **Net exports should remain as the main support of growth, although the outlook for exports remains fragile**

  Although exports increased by 5.6% y/y in January, mainly boosted by non-EU countries (12% y/y), the three months moving average revealed a gloomy picture, as they declined again (-0.6%), although at a more moderate pace than during 4Q12. In addition, export order books fell further in February, thus suggesting that a sustainable recovery in exports could take longer. Nonetheless, the drop in imports was larger than exports, reflecting the depressed domestic demand and confirming that the relatively resilience of imports observed during 2H12 should have been temporary. As a result, the net exports contribution is likely to be positive again in coming quarters, partially offsetting the negative impact of domestic demand that will continue to be there due to the ongoing economic imbalances adjustments.

- **Domestic demand is likely to prove more resilient in coming months**

  Positive news came also from indicators of domestic demand, as retail sales increased strongly in January (4.2% m/m s.a.), implying that sales levels are around 2.5% above the 4Q12 average (when they slumped by -7.4% q/q). Although it is still soon to draw a clear sign from January's figures, the significant improvement in consumers' confidence in February suggests that private consumption could have been more resilient in early 2013, though still shrinking. In addition, the drivers of household consumption remain very weak, with unemployment rate growing to 17.6%. Nonetheless, the strong slowdown of inflation in January by 1.7pp to 0.2% y/y (mainly due to vanishing effect of the VAT hike in January 2012, as the Portuguese national institute of statistics estimates this effect around 1.1pp) and 0% y/y in February means that the moderation of prices in recent months could support households' real disposable income in coming months.

  The better performance of both domestic and external demand was also reflected in the industrial production, that increased by 3.5% m/m in January, offsetting the fall observed in previous months. The level of industrial output in January is 1.3% over the average of 4Q12, after having declined by -3.7% q/q in that quarter. Nonetheless, still subdued industrial confidence and falling industrial orders suggests a bumpy outlook in coming months, while poor expectations about future demand along with tight credit conditions and high idle capacity of firms point to a further decline in investment in the short-run.

- **Downside risks to our economic outlook, as the results for 4Q12 imply a strong carryover effect that could lead of GDP recession of -2% in 2013**

  Our MICA-BBVA model update, with available data until now, estimates a GDP fall of around -0.4% q/q in 1Q13, a somewhat larger fall than that envisaged in our macroeconomic scenario (-0.1% q/q). This is because of the inertia incorporated in the model from the very bad GDP data of 4Q12. Nonetheless, if hard data for February confirm the good performance, our previous estimation of -0.1% q/q cannot be ruled out. This combined with the carry-over effect of a larger-than-expected GDP drop in 4Q12 (around -0.7pp) point to a larger GDP contraction in 2013 as a whole, of around 2%, against our previous estimation of -1.2%. Despite these downward biases, we continue to expect a mild economic recovery in Q213, gaining traction over the second half of the year.

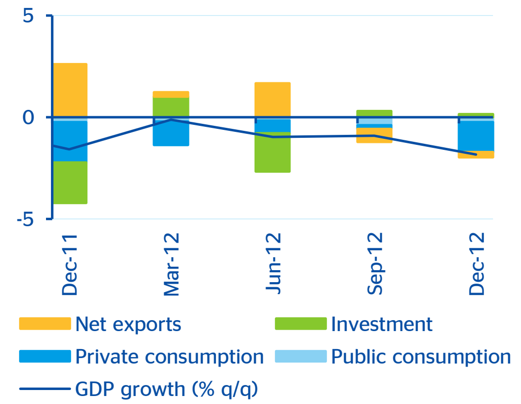
- **More time for fiscal adjustments and possibly longer debt repayment**

The high degree of compliance with the measures agreed with the troika (see chart 7) and the downward revision of growth prospects for external demand have been determinant in the decision to relax the deficit targets previously reviewed in September , 2012. Now the government will have another year to reduce the deficit below the 3% threshold set by the Stability and Growth Pact, the deficit targets are revised from 4.5 to 5.5% of GDP by 2013, from 2.5 to 4% of GDP in 2014 and the 2015 deficit target at 2.5% of GDP (see chart 8).

The government is committed to meet the additional financing needs arising from the revised fiscal deficit target and committed to adopting and publishing a medium-term fiscal program based primarily on spending reduction.

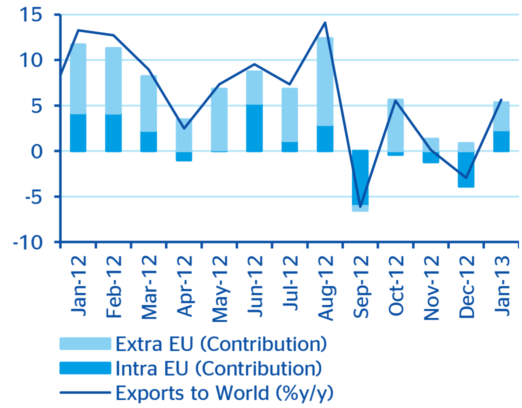
At the last meeting of finance ministers of the Eurogroup, they have approved a flexible repayment schedule of the debt owed to EFSF which corresponds to one third of total debt (about 26 billion euros). The details of the proposed schedule will be announced at the next meeting to be held in Dublin in mid-April.2013.

Chart 1
GDP growth and contributions



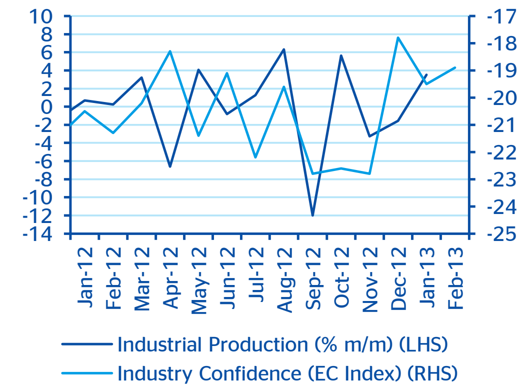
Source: Eurostat and

Chart 2
Contribution to total Exports



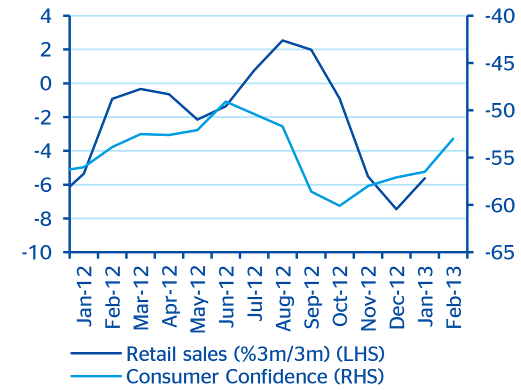
Source: INE Portugal

Chart 3
Industry outlook



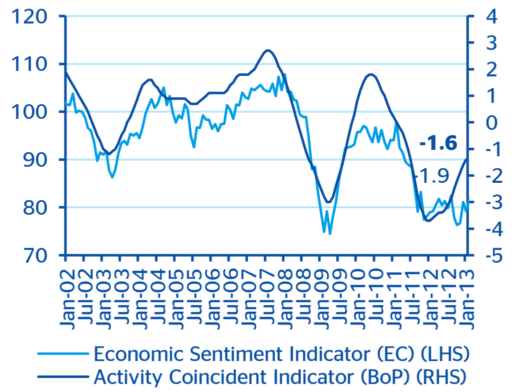
Source: Eurostat and European Commission

Chart 4
Consumer confidence



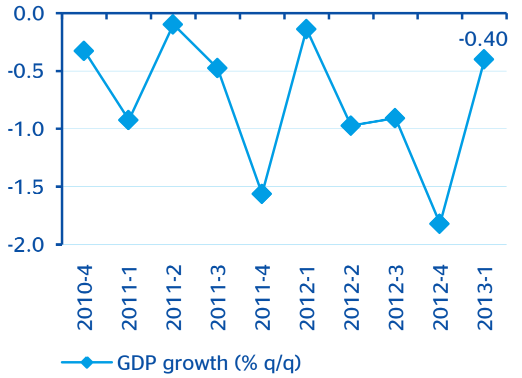
Source: Eurostat and European Commission

Chart 5
Economic Sentiment



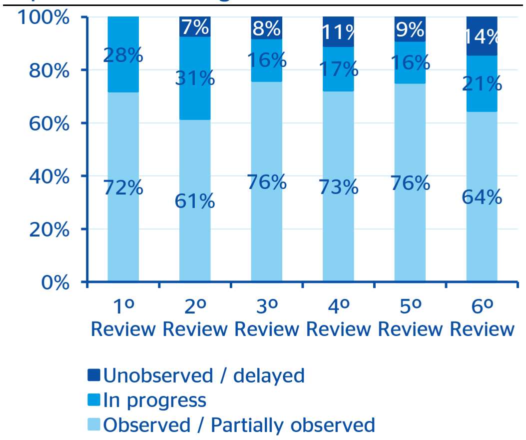
Source: Bank of Portugal and European Commission

Chart 6
Portugal:
GDP growth and contributions (% q/q; avg)



Source: Eurostat and BBVA Research

Chart 7
Implementation of agreed measures (%)



Source: Ministry of Finance, march 2013

Chart 8
Budget deficit targets.
As a percentage of GDP (national accounts)

(f) Forecast; it's not an initial target
Source: Ministry of Finance, march 2013

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