Economic Watch

Portugal

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Economic Analysis

Europe Unit

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Economic activity should stabilize in 3Q13

The unexpected upturn in activity in 2Q13 was due to a temporary rebound in domestic demand

- **GDP grew by 1.1% q/q in 2Q13, above the expected rate, with a strong domestic demand component**

  Growth in the second quarter (1.1% q/q) surprised sharply upward than expected by BBVA Research and the rest of the analysts (BBVA Research: -0.1%; Consensus: +0.1%) and is obviously not sustainable in the short term. Part of the surprise was due to temporary factors (different dates for Holy Week and construction investment), while other factors will be difficult to consolidate over time, such as the significant contribution of increased inventories to growth.

  The breakdown by components indicates that quarterly GDP growth was mainly a response to domestic demand contributing positively to growth (with a rise of +0.8 pp in contribution after a fall of +2.1 pp in 1Q13), after more than two years of negative or zero growth (Chart 1). Although it is true that this result was basically due to the major inventory accumulation (up +0.5 pp after a fall of -1.1 pp in 1Q13), which is a very volatile component, it is worth noting that part of the growth was due to private consumption contributing positively for the first time in the last two and a half years (up +0.3 pp after a fall of -0.5 pp in 1Q12), and investment no longer draining growth after two quarters of falls in a row (0.0 pp after a fall of -0.4 pp in 1Q13).

  In addition, foreign demand continued to contribute positively to economic growth, but in a more moderate way (+0.3 pp following on from +1.6 pp in 1Q13), boosted by the upturn in domestic demand. However, exports continued with their positive growth trend; in fact, they contributed more to growth than in the previous quarter (+2 pp compared with +1.2 pp in 1Q13).

- **Exports also surprised upwards in 2Q13, mainly due to greater demand from countries outside the European Union**

  Analysis by destinations reveals that in the second quarter of the year the countries that contributed most to export growth were those outside the European Union (+1.9 pp compared with +0.8 pp in 1Q13) (Chart 2). Their growth here was in fact higher than in the Member States (+1.5 pp after +0.4 pp in 1Q13). The most notable contributions were from OPEC countries (+0.9 pp after a fall of +0.3 pp in 1Q13) and the Portuguese-speaking PALOP[1] countries (+0.3 pp after 0 pp in 1Q13); while Spain and France were the main destinations within the European Union, with contributions of +1.1 pp after +0.8 pp in 1Q13 in the case of Spain and +0.6 pp after -0.1 pp in 1Q13 for France.

1: PALOP: Acronym in portuguese of portuguese-speaking African countries (Países Africanos de Língua Oficial Portuguesa).

However, the latest data on exports, although available only until July 2013, indicate that the good performance of exports will not remain so strong in 3Q13, mainly due to waning demand from countries outside the European Union and the increased demand from EU Member States will not be able to offset this decline.

- **Our MICA-BBVA model estimates that the economy could contract slightly again in 3Q13, although it shows signs of stabilizing**

The available data for the third quarter point to a stabilization or slight contraction in economic activity rather than the maintenance of the strong rate of growth recorded in the previous quarter. The European Commission's confidence indicators, available through August, have continued to show a continued trend for improvement since the start of the year, and although they remain at historically low levels (one standard deviation under the mean in the long term), they have reached similar levels to those recorded in 2Q11, when the economy was practically stagnant. By components, some signs of movement can be seen in domestic demand. On the positive side, consumer confidence continued to improve, particularly in July and August, reflecting in part the somewhat less negative situation of the labor market (a decline in the unemployment rate of around -1 pp from 1Q13 to 16.5% in July, using seasonally adjusted data) and a more moderate decline in available income (down -1% in the first quarter, following a fall of -2.5% in the previous year). This has also been reflected in retail sales, which once more increased in July for the fourth month in a row and suggest some resilience in private consumption following the upturn in the previous quarter.

In contrast, industrial output in July showed less optimistic signs, as it decreased for the second month in a row, with a significant contraction in activity from the start of the quarter (down -3.3% on 2Q12 and -2.2% over the quarter). Even so, the indicators of industrial confidence show a less optimistic outlook for the next few months, while output in the construction sector increased strongly in July.

Despite somewhat better expectations for domestic demand and the strength of external demand, it is still unlikely that this could be reflected clearly in an improvement in investment, above all given the low capacity utilization in companies (under 74%, nearly two standard deviations below the historical average of 80%), so we expect investment to remain practically flat.

Support from the external sector continues, although the orders from abroad show some signs of a slowdown, mainly due to lower demand outside the European Union (where exports decreased -9.3% m/m in July), which has only been partly offset by greater demand from European Union countries (up +3.1% m/m). The expected recovery for the European Union as a whole, in addition to signs of improved activity in some of the main trading partners such as Spain, should continue to contribute to the good performance of exports. Moreover, support from the external sector could moderate due to increased imports (up +2.4% m/m in July), which are often linked to the purchase of intermediate goods or investment.

Overall, and although the quantitative data are still very limited, our MICA-BBVA model for the short term estimates that GDP could contract slightly by around -0.2 - -0.3% q/q (Chart 3), compared with our forecast three months ago of a practical standstill. These quarterly rates are consistent with a year-on-year decline of -1.6 - -1.7% (moderating from the decrease of -2.2% in 2Q13), slightly below the Bank of Portugal's synthetic indicator of output, which in July improved to -1.1% y/y from an average of -1.7% y/y in 2Q13.

- **These data, along with the strong positive surprise in GDP in 2Q13, have a positive knock-on effect for the year as a whole**

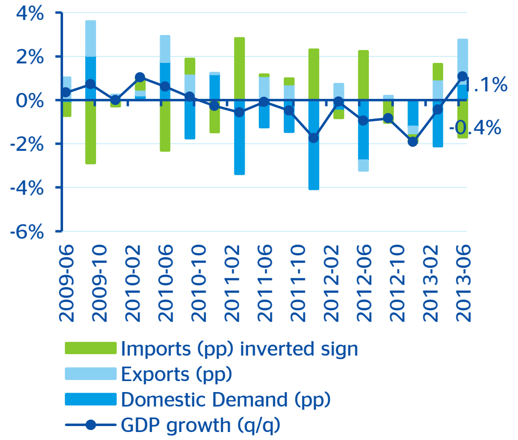
  Taking into account this updated forecast for 3Q13, together with the strong upward surprise in 2Q13, and maintaining our growth profile during the forecast horizon (a slight average growth of around +0.1% q/q), the Portuguese economy could contract just under -2% this year, compared with our forecast of -2.3% three months ago. We still expect weak growth for 2014 of around +0.5%.

- **The ruling by the Constitutional Court on the "requalification scheme" will not affect compliance with the 5.5% deficit target for this year**

  As of July 2013, preliminary data for the deficit of the public sector, using the performance criterion[2] [3], are of €5,226 million (around 3.2% of GDP). This is in line with the achievement of the fiscal target of 5.5% of GDP for this year. Including these data in our models, we forecast that the government will comply with the deficit target for 2013 (Chart 4), even taking into account the latest ruling by the Constitutional Court on the "requalification scheme", whose direct effect in 2013 is estimated at €48 million (0.03 pp of GDP), and also the payment of the extra monthly bonus for civil servants in November, which will make expenditure on personnel increase by €300 million (0.2 pp of GDP) in the last quarter of the year. In addition, recently the government has presented parliament with a revision of the "special mobility[4]" scheme, which will mitigate the economic effects of the Constitutional Court's latest ruling. To sum up, unless there is an unexpected deterioration in the remainder of the year, it does not appear that after the cancellation of the measures to reduce the public administration at the end of August there will be problems in achieving the fiscal target this year.

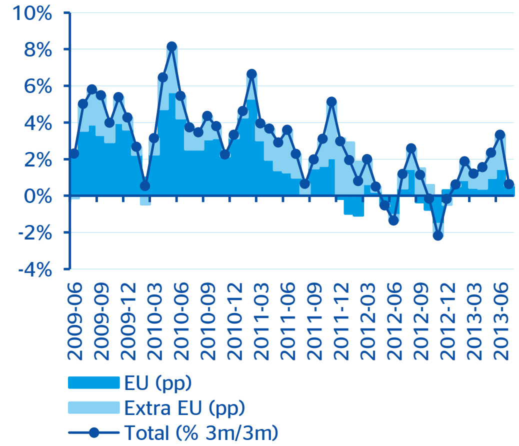
2: The performance criterion is the one used for the target set by the Troika and excludes some operations, among the most important being expenditure related to the regularization of debt of the Local Administration Assistance Program (€271 million) and income obtained from the transfer of pension funds to the public sector (€48 million).
3: The public administration includes: 1) Central Government (State + autonomous services and funds + reclassified state-owned companies; 2) regional government (Madeira + Azores); 3) local government; 4) the Social Security system.
4: Under this proposal the officials who are in the new program of "special mobility" are going to earn only 60% of their salary, no be less than a threshold of 485 euros (the minimum wage), and after the year this percentage would drop to 40%, with no limit of time (in the previous decree-law the officials would have been fired after the year or would have been gone to a waiting list without payments). It is estimated that between 15 000 and 25 000 staff would be potentially affected by this program.

Chart 1
Portugal: GDP growth and contributions (% q/q; avg)



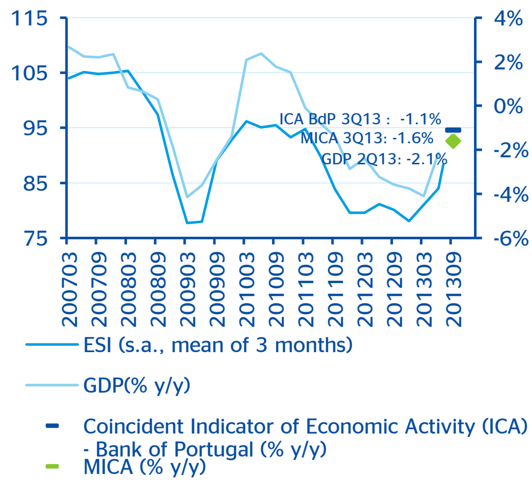
Source: Eurostat and BBVA Research

Chart 2
Exports (sa): contribution by areas



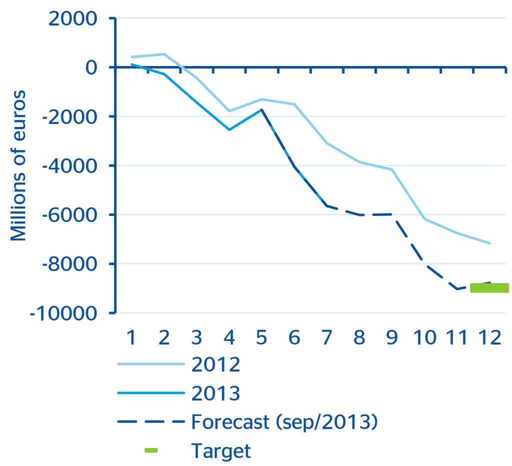
Source: INE and BBVA Research

Chart 3
Observed GDP and MICA, ICA Forecasts (% a/a)



Source: Eurostat, Bank of Portugal and BBVA Research

Chart 4
Public deficit forecast



Source: DGO and BBVA Research

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