BBVA | RESEARCH

Economic Watch

Portugal

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Economic Analysis

Eruope

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The economy is recovering faster than expected

As well as support from global demand, there is greater momentum in private spending

- **Improved demand, particularly from abroad, appears to be underpinning the incipient recovery**

  In 4Q13, activity indicators diverged: while industrial production registered a quarterly increase of 2.5%, closing 2013 with an increase of 0.9% YoY, mainly driven by exports, retail trade shrank by 1.7% in 4Q13 and by 1.8% in the year as a whole.

- **Unemployment and labour costs continue to fall**

  The unemployment rate fell again in December to 15.4%, a reduction of 1.9pp in the last twelve months (from 17.3% in November 2012). On the other hand, the final figures for labour costs recorded a drop in 4Q13 (-0.4% YoY) due to a sharp fall in the "other salary costs" item (-3.3% YoY) while the "salary costs" component recovered slightly after declining for two years (+0.5% QoQ).

- **Low inflation rates help to compensate the fall in income and improve exports' competitive advantage**

  Headline inflation (HICP) slowed slightly in January again by 0.1pp to 0.1% YoY, essentially due to the fall in industrial goods prices, while the fall in energy prices slowed and food prices eased a little, resulting in core inflation slowing as well, from 0.2% YoY in December to 0.1% in January.

- **Confidence is significantly higher, helping the private sector to take spending decisions**

  The European Commission's economic sentiment index went up significantly in November and, particularly, in December, accelerating the positive trend that we have seen since 2Q13. Nevertheless, in January the rate of improvement slowed and is still at levels that are slightly below the historical average, suggesting that the recovery may be progressing at around its average growth rate (about 0.3% QoQ).

- **The recovery gained traction in 4Q13, more than we had expected, and the MICA-BBVA model currently forecasts 0.2% growth for 1Q14, representing an upside risk to our 0.8% forecast for 2014**

GDP grew 0.5% QoQ in 4Q13, beating our forecasts that the recovery would progress at a relatively stable rate (around 0.2% QoQ). Although the detail of the components of that growth is not yet available, the greater resilience of both private spending and of investment could be behind this speed-up in activity, which came in conjunction with support for exports. In addition, GDP growth was also revised slightly upwards in 3Q13 by 0.1pp to 0.3% QoQ, which means that there have been three consecutive quarters of robust growth (1.1% QoQ in 2Q13). Despite that, after the heavy falls in output in 2012, particularly at the end of the year, and in 1Q13, GDP for the year as a whole shrank 1.4% (BBVA Research: -1.5%).

The 3Q13 revision of GDP growth, together with greater than expected growth in 4Q13, is having a positive knock-on effect on 2014 growth of around 0.3pp. In addition, bearing in mind the information available to date (still limited, basically to confidence indexes for January), our MICA-BBVA model estimates quarterly GDP growth of around 0.2% in 1Q14 (compared to 0.1% QoQ in our scenario). All this creates certain upside risks to our growth forecast for 2014 (0.8%), since if we assume a relatively stable rate of expansion for the rest of the year (around 0.2% QoQ), the Portuguese economy could end up growing by more than 1% (around 1.3%, similar to our forecast for 2015).

- **Medium-term forecasts: exports will continue to be the main driver for growth in our forecast horizon**

Pending the 4Q13 data, we think it is likely that exports will have grown around 6% over 2013 as a whole, supported both by recovery in global demand and by the moderation in domestic prices (after a reduction in labour costs of slightly more than 3% since 2007); this partly offset the appreciation of the euro. For the forecast horizon, exports should continue to grow at a relatively strong rate (our forecast is for 5.3% in 2014 and 4.9% in 2015, compared to average growth of 5% between 1996 and 2008), sustained by the acceleration in world growth, and also by a better outlook for the eurozone as a whole (the combined quota of exports to Spain, Germany and France is 47%). As well as the above, there is also the euro weakening which we are expecting in forthcoming quarters, together with the positive differential in prices, given the low rates of inflation.

Robust export performance will be crucial for a recovery in investment, but greater momentum in imports will gradually reduce the weight of net exports' contribution to growth to 0.8pp and 0.4pp in 2014 and 2015, respectively, from the 1.3pp we estimated for 2013.

- **Investment, above all, and private consumption will slowly improve. Despite budget adjustments, domestic demand will cease weighing on growth in 2014**

  We have seen signs of correction and recovery in domestic demand drivers since 2Q13, which has resulted in a gradual improvement of private spending.

  Within the forecast horizon, investment will continue benefiting from buoyant global demand and also from the recovery of the country's main partners in the EMU and improved access to credit. As a result, our forecasts show a moderate increase in investment for 2014 (1.4%, after having contracted around 8% in 2013) before speeding up in 2015 (3%).

  With this uptick in activity, employment increased by around 1% QoQ both in 2Q13 and 3Q13, with a noticeable fall in the unemployment rate of around 2.5pp at the beginning of the year to the 15.3% recorded in 4Q13, helped in part by the new labour market framework. Even so, disposable household income in the first three quarters last year was practically stagnant (after the heavy falls in the two previous years) which, together with the continued improvement in consumer confidence, will be reflected in moderate growth in private consumption in 2014 (around 0.2%) that will start gaining momentum next year (0.7%). These rates, however, are much more moderate than those recorded before the crisis (average growth in private consumption of 2.6% between 1996 and 2008), while the accumulated imbalances are still being corrected.

  Finally, the ongoing budget adjustment will continue weighing on the reduction of public spending in the forecast horizon, although, once most of the adjustment has taken place and the weight on the public sector has diminished, our forecasts indicate a more gentle decline in public spending (-2.3% in 2013, -1.9% in 2014 and -0.5% in 2015) after drops of around 5% recorded in 2011 and 2012.

- **The government comfortably met its 2013 budget deficit target of 5.5%. In 2014, the deficit could come in under target (4%) if the measures planned are introduced**

  At the end of January, the government presented its provisional deficit figures for the public sector, according to the cash (settlement) system, for the whole of 2013, according to which, in terms of complying with the Economic and Financial Adjustment Programme (EFAP), the deficit stood at EUR7,151.5bn (4.7% of GDP), about EUR1,748.5bn below the target set. The deficit in 2013 according to the Maastricht parameters was around 5.1% of GDP[1] in 2013, below the 5.5% forecast by the government when the 2014 budget was put together.

  This good performance was due mainly to higher tax revenues and controlled spending. The higher tax revenues are partly accounted for by greater economic growth than forecast, but also because of the tax amnesty in place since the end of 2013, which resulted in additional revenues of EUR1.045bn (EUR545mn more than initially expected) as well as higher revenues from personal income tax due to the increase in the average tax rate.

1: Includes capital transfers from BANIF (0.4% of GDP)

For 2014, the government has announced budget adjustments worth EUR3.9bn (approximately 2.3% of GDP), among which the cut in civil servants' salaries is a major item (with cuts starting from monthly wages of EUR675, of between 2.5% and 12% of the wage) and the additional measures presented by the government after the Constitutional Tribunal ruled that the pension convergence system was unconstitutional (the application, once again, of the one-off solidarity contribution, widening its base, and the increase in contributions from civil servants to their healthcare system).

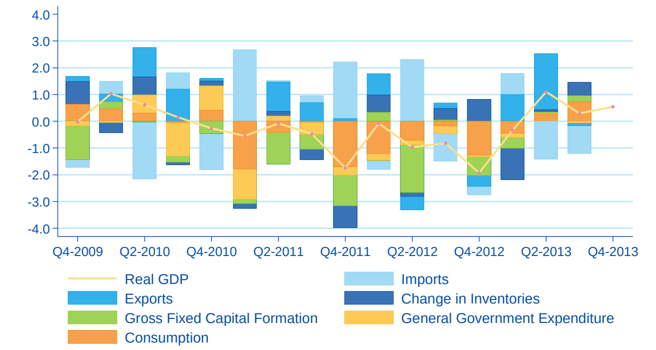
Bearing in mind the tax measures announced by the government for 2014 and our below-forecast estimate of the nominal deficit for 2013 (5.1% of GDP), in 2014 the government could meet the target set (4% of GDP), and even have some room for manoeuvre. In fact the 2014 deficit could reach 3.6% of GDP, 0.4pp below the target, assuming that all the fiscal measures are kept in place, and that the economic growth scenario materialises.

Portugal

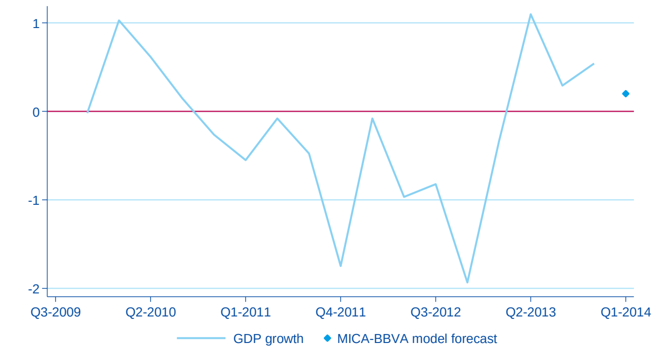
National accounts: The recovery gains traction in 4Q13, growing more than expected

GDP grew by 0.5% QoQ in 4Q13, more than expected (BBVA: 0.2% QoQ and Consensus: 0.1%). A recovery in internal demand and acceleration in exports will be behind this performance. The recovery will continue in 1Q14 (+0.2% QoQ)

GDP (%QoQ) and contribution by component (pp)*



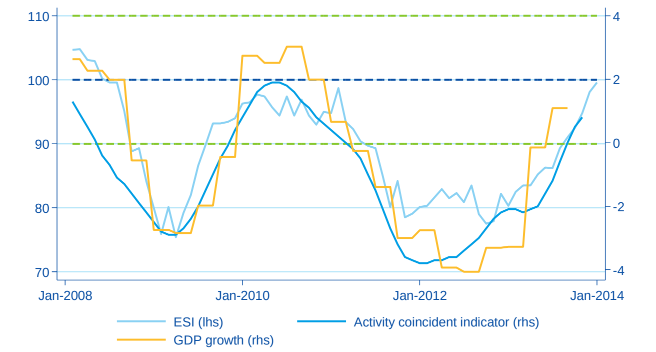
GDP growth (%QoQ) & forecasts*



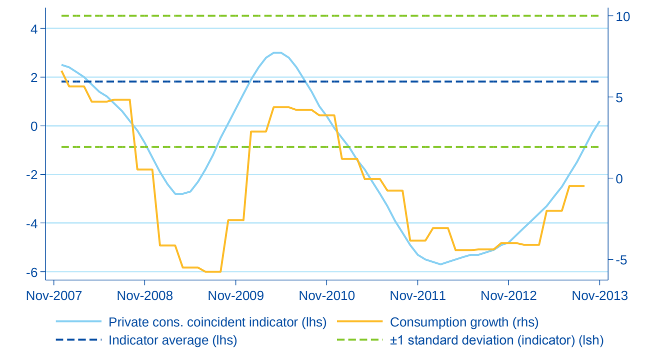
Confidence: in January the positive trend begun a year ago continues

According to the EC's ESI index, confidence continues to move upwards towards its historic average, recording 99.6 points in January. The BoP output coincident indicator (to November) also points to the likelihood of the economy staying at the levels reached in 3Q13

Confidence (ESI) & coincident activity indicator*



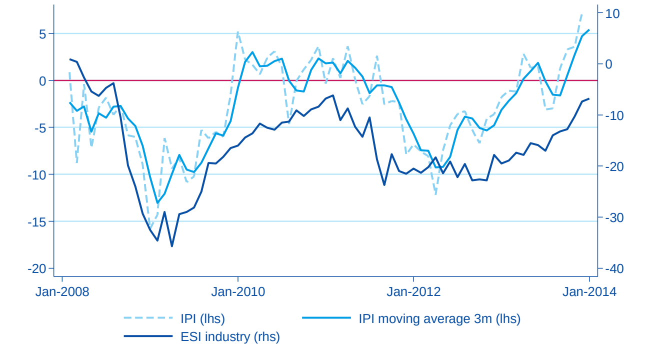
Private Consumption Coincident Indicator and Private consumption (%YoY)*



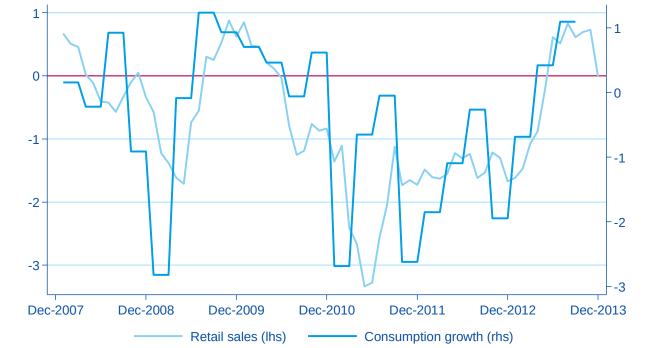
Output: industrial production improves and retail trade shows signs of weakness

Industrial production grew in the last quarter by 2.5% QoQ over 3T13, while retail sales went down by 1.7% QoQ because of the heavy fall in December.

Industrial output (% YoY) and industrial confidence (ESI)**



Retail trade (% 3m/3m) and consumption growth (% QoQ)*

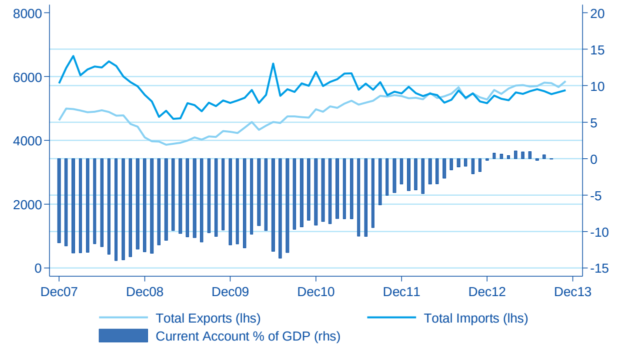


*Source: HAVER and BBVA Research

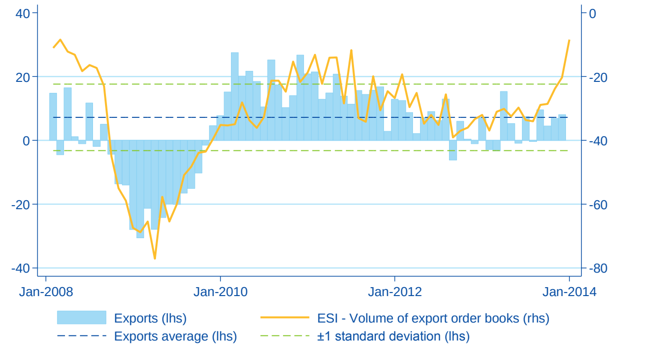
Foreign sector export orders suggest that exports will continue growing in 1Q14

In 4Q13 exports grew by 1.7% over 3Q13 (0.1% QoQ), while growth in imports has been more moderate, at around 0.8% QoQ over 3Q13 (1.7% QoQ).

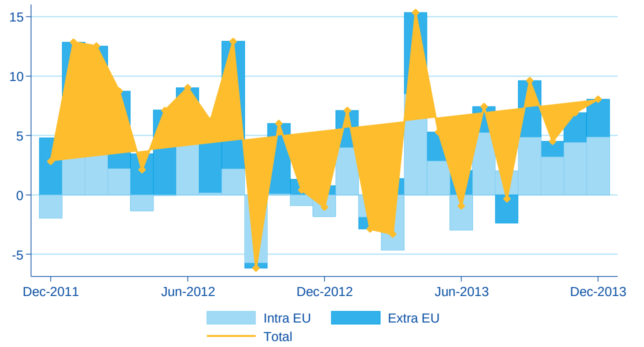
Current account (% GDP)*



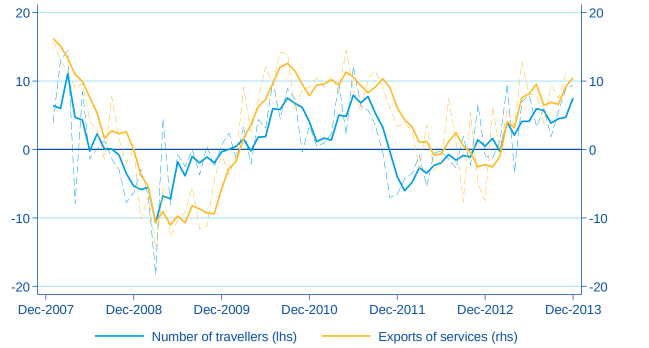
Exports (% YoY) and volume of export order books*



Exports by destination (% YoY)*



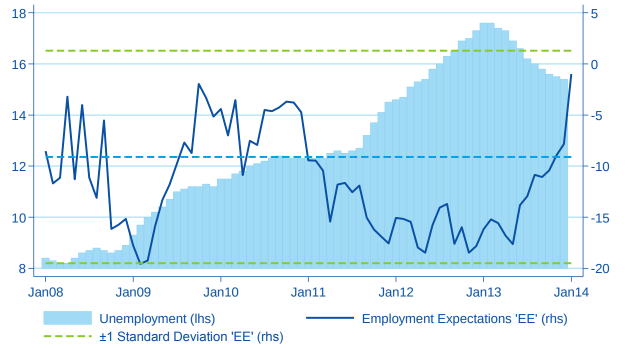
Tourism and service exports (% YoY)*



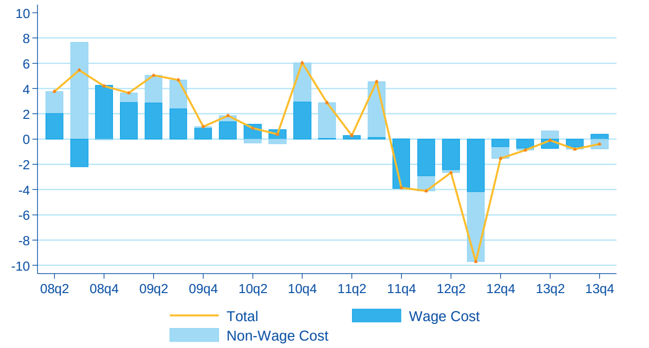
Labour market: unemployment continues to fall and labour costs stay low

The unemployment rate went down again slightly in December, settling at 15.4%, an improvement of 1.9pp if we compare it with the 2012 figures. Latest labour cost figures show a drop in 4Q13 (-0.4% YoY) due to a strong fall in the "other wage costs" component (-3.3% YoY) while the "wage costs" component recovered slightly after two years of losses (+0.5% QoQ)

Unemployment rate (%) and employment expectations*



Labour costs in the business sector (% YoY)*



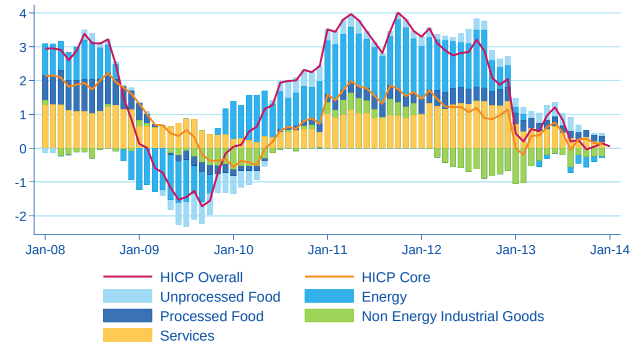
* Source: HAVER and BBVA Research

Prices: inflation goes down again in January and remains low

Headline inflation (HICP) went down again in January by 0.1pp to 0.1% YoY (mainly as a result of the fall of prices in industrial goods), and core inflation behaved similarly.

Headline and core inflation rate (% YoY)*

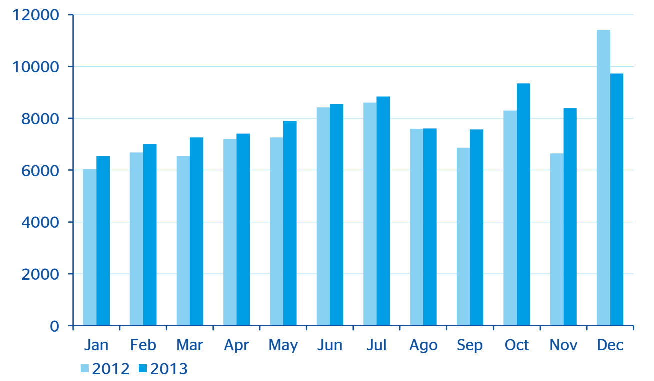
Inflation by component (contribution in %)*



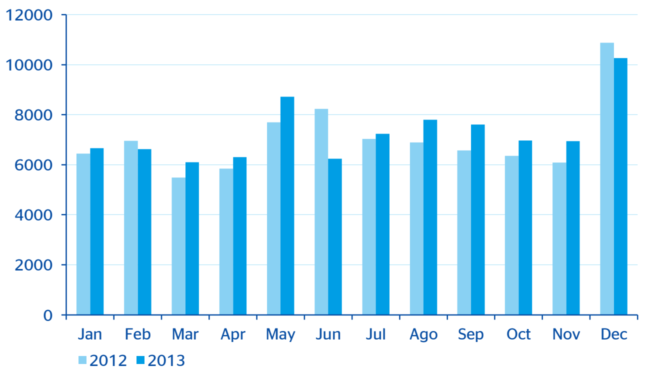
Public sector: the government meets the deficit target

The latest budget execution figures show that the government will meet the deficit target of 5.5% of GDP.

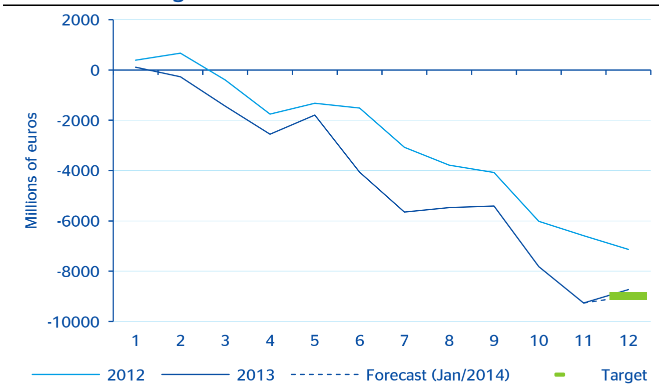
Government expenditure (comparison with the previous year)*



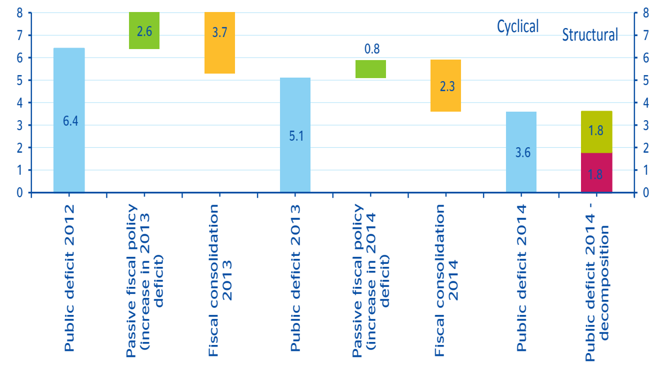
Government revenue (comparison with the previous year)*



Fiscal deficit target*



Breakdown of fiscal deficit (cyclical and structural)*



* Source: HAVER and BBVA Research

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