MACROECONOMIC ANALYSIS

Portugal: growth will continue to gain traction, but at a moderate pace

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We expect GDP growth of 1.5% in 2015, but the risks are to the downside and are linked to the performance of the euro area

The recovery moderates in 3Q14, confirming our forecast

Portugal's GDP increased by 0.2% QoQ in the third quarter of 2014, in line with our forecast (BBVA: 0.2% QoQ, consensus 0.4% QoQ), supported by the gradual improvement in domestic demand, especially private consumption, while the external sector contributed negatively due to the strong growth in imports. This growth is similar to, but somewhat lower than, that of the second quarter (0.3% QoQ), which was based more on external demand and partly offset the decline in GDP observed in 1Q14 of -0.4% QoQ (Figure 1) which was largely due to temporary factors.

With few data available for 4Q14, limited to confidence for October, our MICA-BBVA model suggests that recovery will continue at a pace similar to 3Q14, with growth of 0.2% QoQ.

Confidence and activity indicators reflect the improvement of domestic demand

In recent months, the continued improvement in the level of consumer confidence, encouraged by the positive trend in the unemployment rate, is being reflected in an increase in retail sales (+3.1% QoQ in 3Q14). On the other hand, after the good performance in the second quarter, industrial production may have declined slightly as was advanced by the economic sentiment indicator for the European Commission (ESI), which slowed between July and September, although remaining at high levels (Figure 5). In terms of external demand, exports of goods increased again in 3Q14, but moderation of foreign orders, due to the worsening situation in the trading partners of the euro area, could be cooling the positive trend. Moreover, the thrust of the tourism sector may have lost some steam if compared to 2Q14. The increase in imports, however, reflects the gradual improvement in domestic demand.

Unemployment continues to decline and employment grows

The Portuguese labour market continues to improve, with a rapid reduction in unemployment (-0.6pp in 3Q14 and -2.1pp in the last twelve months) that fell to 13.6% in September, but remains above the average of the eurozone. The dynamics of job creation were also maintained in the third quarter (1.1% QoQ) in a general context of wage moderation in the private sector (Figures 11 and 12): labour costs fell throughout 2Q14 (-1.8% after 0.5% YoY), especially in the wage component (-1.5% YoY), but should increase towards the end of the year after the upward revision of the minimum wage.

Inflation accelerates slightly in October

After seven months at negative rates, headline inflation (HICP) remained stable in September (0.0% YoY after -0.1% YoY) and accelerated slightly in October (0.1% YoY), thanks to the moderation in the fall in food prices, particularly fresh food (Figures 13 and 14). Despite the downside risks associated with the recent decline in oil prices, headline inflation should continue to rise slightly in the fourth quarter and next year, resulting in an average annual inflation rate of zero in 2014 and 0 7% in 2015.

Forecast: expected acceleration in 2015 to 1.5%

The improvement in the labour market, household confidence and low inflation should boost the gradual recovery of private consumption, which should then grow at a relatively stable and robust pace (about 0.3-0.4% QoQ) on the forecast horizon. As a result, private consumption will grow by 1.6% in 2014, slowing slightly in 2015 to 1.3% YoY, after the disappearance of the strong seasonal rebound in household spending late last year. The key factors behind the increase in investment since mid-2013 have continued (improving domestic demand and recovery of external demand, despite the worsening of the eurozone, together reducing financing costs and a gradual improvement in access to credit) and are reflected in the sharp rise in investment in equipment and machinery, although the severe correction to investment in the construction industry is still a heavy burden. However, the investment will grow about 1.3% in 2014 (after five consecutive years of heavy falls), and we expect it to accelerate to around 2.8% in 2015. At the same time, improved domestic demand is leading to a strong increase in imports (5.5% in 2014 and 4.6% expected in 2015), so despite robust sales abroad (4% in 2014 and 5.7% in 2015), net exports will have a negative contribution to growth in 2014 and slightly positive in 2015 (Figure 1). The only component that will continue to fall is public consumption, hampered by budget constraints (-0.5% and -0.8% in 2014 and 2015). Nevertheless, we estimate that the economy will grow 0.9% in 2014, and accelerate to 1.5% in 2015. There are, however, downside risks to this forecast, mainly linked to lower growth now expected for the eurozone as a whole, which the Portuguese export sector is very much dependent on, and whose evolution is essential to underpin the recovery in investment (Figure 9).

The public deficit is close to meeting the target of 4% of GDP in 2014

The 2014 budget execution is being determined by the evolution of revenues, which are performing better than originally planned: improving domestic demand, the gradual reduction in unemployment and the efficacy of the fight against tax fraud are bringing in additional income which is offsetting the cancellation of some cuts in public spending by the Constitutional Court. The deficit, therefore, should be set at 4% in 2014, which means that the adjustment of the structural deficit would be about 0.6pp, meeting the medium-term objectives (Figure 18). In respect of 2015, the budget has an austere tone and estimates a deficit of 2.7%, 0.2pp above the target set in April's Fiscal Strategy Document. Both the European Commission and the International Monetary Fund are more pessimistic with their deficit forecasts than the Portuguese government, and believe that Portugal will not exit the Excessive Deficit Procedure, after six years with deficits higher than 3%. Our forecasts are more in line with the government’s, but are subject to the extension of the tone of the recovery in Portuguese economy and to the implementation of all the measures proposed in the 2015 budget.

Portugal

National accounts: the MICA-BBVA model estimates 0.2 QoQ growth in 3Q14

GDP grew by 0.3% QoQ in the second quarter of 2014. The moderation in consumption (both public-sector and private) was offset by the recovery in exports.

Figure 1
GDP (%QoQ) and contribution by components(pp)*

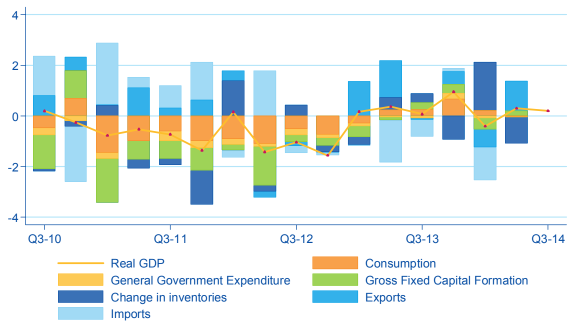
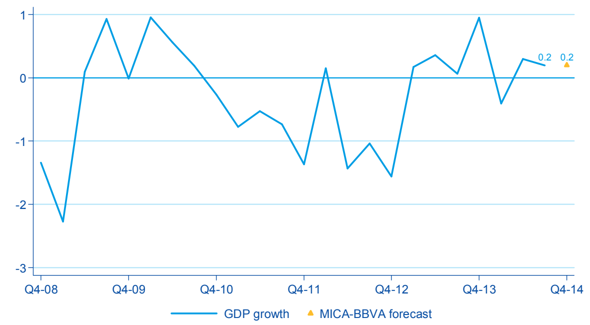


Figure 2
MICA-BBVA: GDP growth (%QoQ) and forecasts*



Confidence: the Economic Sentiment Indicator still growing in 4Q14

According to the ESI, the EC's indicator, business confidence improves again in early 4Q14, both in services and in industry, as consumer confidence is above the average for 3Q14.

Figure 3
Confidence (ESI) and coincident activity indicator*

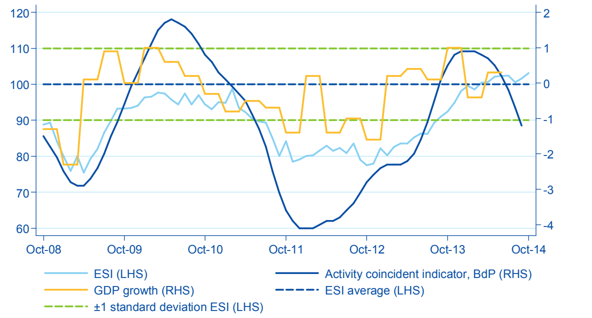
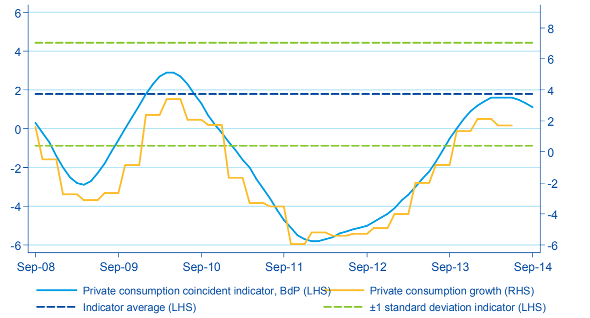


Figure 4
Coincident consumption indicator and private consumption (%YoY)*



Activity: industrial production reduces and retail sales improve in 3Q14

The recovery of industrial production slowed in 3Q14. Retailers, however, are rebounding strongly (3.1% up from the average in 2Q14), supported by high levels of consumer confidence.

Figure 5
Industrial production (%YoY) and confidence*

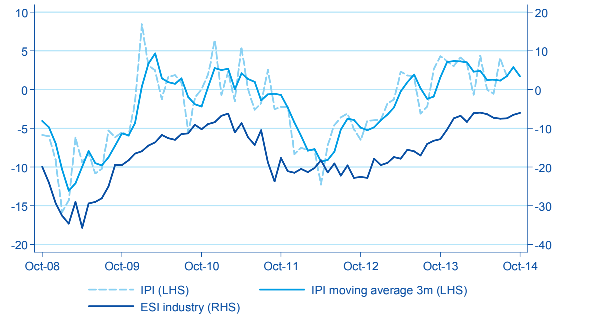
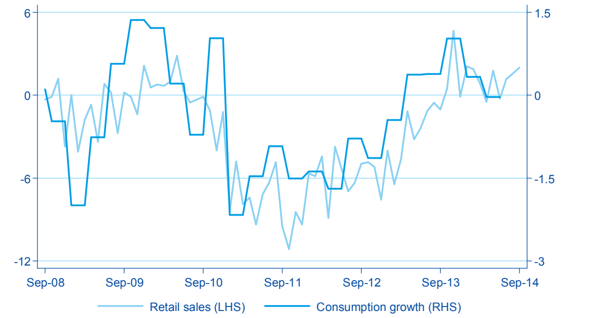


Figure 6
Retail sales (% YoY) and private consumption (% QoQ)*



* Source: HAVER and BBVA Research

Foreign sector: goods exports continue to recover

Goods exports continue to improve after the poor results at the beginning of the year. Meanwhile, services exports continue to increase, although the tourism sector may have cooled down in 3Q14.

Figure 7
Exports and imports (YoY growth, MA3p %)*

Figure 8
Exports (% YoY) and export orders *

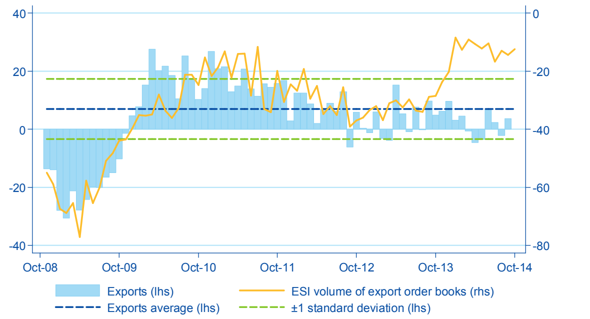


Figure 9
International trade by destination (% YoY, sa)*

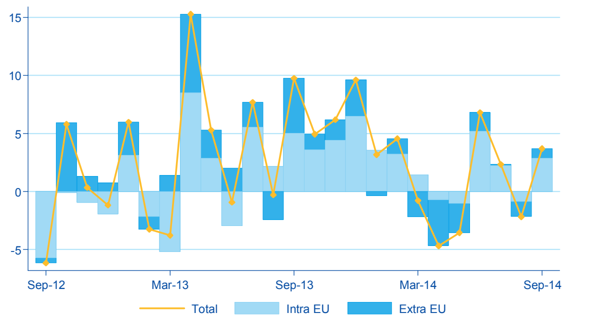
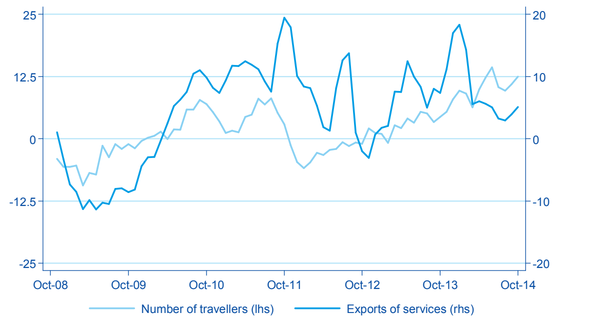


Figure 10
Tourism and services exports (% YoY, MM3p)*



Labour market: labour costs fall and the unemployment rate is still going down

The unemployment rate has fallen by 2.1pp in a year, to 13.6%, in a clear downward trend, although this is not putting upward pressure on wages (-1.8% YoY in 2Q14) and, once again, more jobs were created (1.1% QoQ in 3Q14).

Figure 11
Unemployment rate (%) and employment expectation *

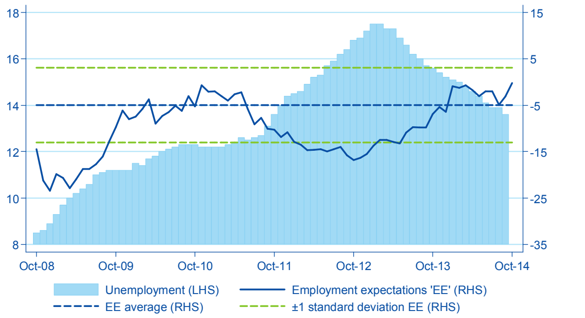
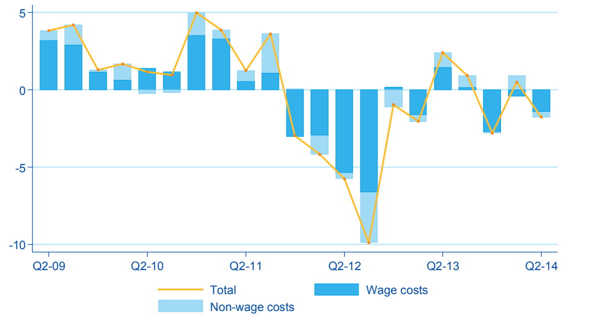


Figure 12
Labour costs in the business sector (%YoY)*



* Sources: HAVER and BBVA Research

Prices: inflation accelerates slightly in October

Headline inflation (HICP) remained stable in September (0.0% YoY after -0.1% YoY) and accelerated slightly in October (0.1% YoY), thanks to the moderation in the fall in food prices, particularly fresh food.

Figure 13
Inflation rate, headline and core (%YoY)*

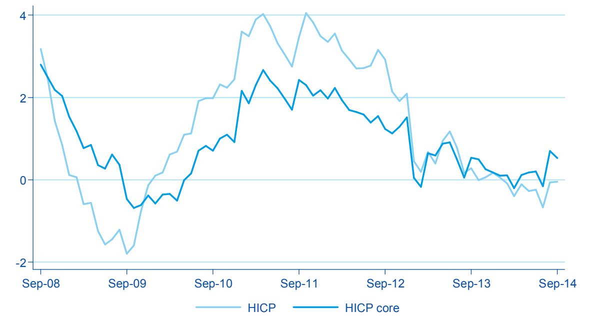
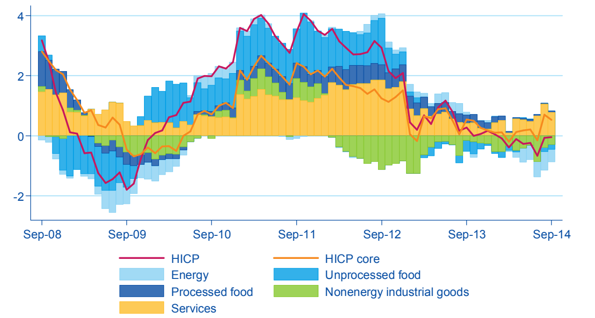


Figure 14
Inflation by components (contribution by %)*



Public finances: the fiscal accounts, close to reaching the budget target

To September 2014, the public administration's accounts indicate that the new deficit target, of 4% of GDP, will be met. Higher-than-expected income offset the increase in expenditure caused by a change in the payment schedule to employees and pensioners and the wage increases to civil servants, by virtue of the decisions of the Constitutional Court.

Figure 15
Government expenditure (comparison with the previous year)*

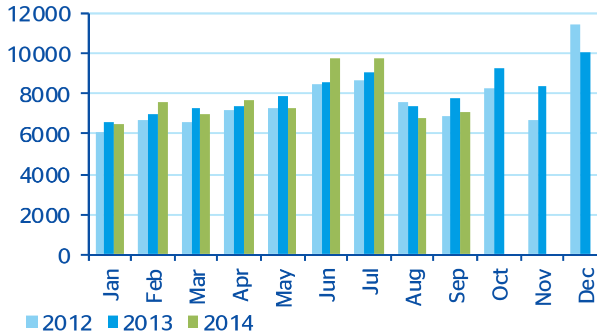


Figure 16
Government revenue (comparison with the previous year)*

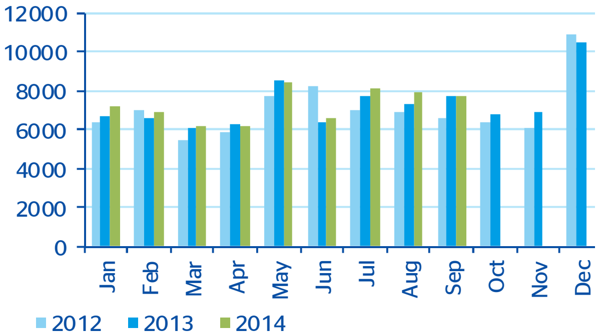


Figure 17
Public and private debt (% of GDP)

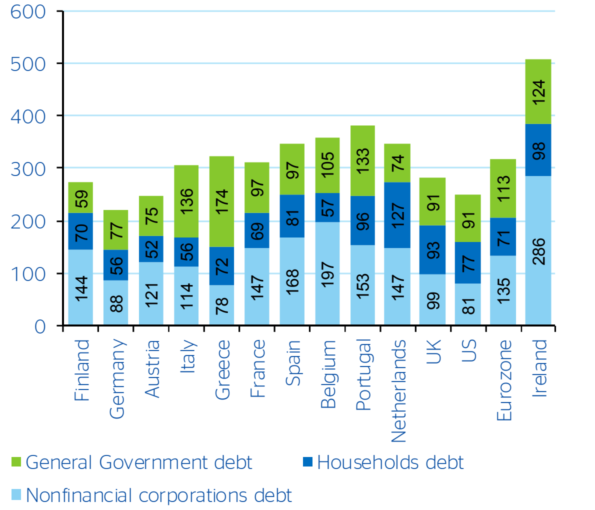
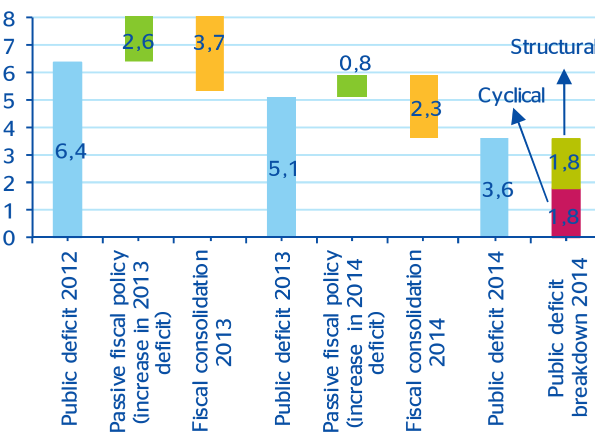


Figure 18
Breakdown of fiscal deficit (cyclical and structural)*



* Sources: HAVER and BBVA Research

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