ECONOMIC ANALYSIS

Portugal: Weak growth and forecasts without changes for 2016

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National accounts have again provided a weak growth figure, somewhat lower than expected, in the fourth quarter (0.2% QoQ), and the latest activity data have not been positive, despite the greater strength of some confidence data. For 2016, lower energy prices should support demand, but increased uncertainty about global growth and financial variables might have an impact on exports and investment, so we are not changing our growth forecast of 1.3%. Given this forecast and higher debt spreads, the risks of non-compliance with the deficit target are high.

Recent developments

- Growth in Portugal has been weak, lower than expected in the second half of 2015. After growing by 0.5% QoQ in the first two quarters of 2015 and stagnating in 3Q15, GDP grew again later in the year (+0.2% QoQ), but somewhat below our forecast for a greater acceleration (Figure 1). The make-up of growth for the fourth quarter is yet to be published, but the information available suggests that the major negative surprise could come from the negative contribution of domestic demand and, in particular, the decline in investment. By contrast, a larger decline in imports relative to exports would have resulted in a positive contribution from net exports.
- During the fourth quarter of 2015, confidence stabilised at high levels (Figure 3), with the European Commission's economic sentiment indicator (ESI) above pre-crisis levels. The first figures for 1Q16 show a slight improvement, with particularly strong confidence shown by households, offset by the slowdown in the services sector.
- These relatively robust data have not been reflected so far in activity indicators: industrial production fell for the second consecutive quarter after going up in 2Q15, while retail sales fell 2% QoQ, having increased over the previous three months (Figures 5 and 6). On the external side, the drop in goods exports (-0.3% QoQ), was more than offset by the decline in imports, which had already fallen sharply in 3Q15 (-0.9% QoQ in 4Q15 after -5.5% QoQ), in part related to the contraction in investment and slower growth in foreign sales (Figures 7 and 8).
- The unemployment rate, whose downward trend was interrupted in 1Q15 after declining for seven quarters, has again fallen significantly since then, standing at 11.8% in December, 1.6 points lower than a year earlier (Figure 11). Job creation slowed down in 3Q15 (0.4% YoY after 1.9% YoY in 2Q15), growing below what had been observed in the previous six quarters, although available data until December point to the fact that it could have sped up again in 4Q15 (1.3% on 3Q15). Moreover, labour costs in the private sector accelerated (2.5% YoY in 3Q15, from 2.3% YoY in 2Q15), especially in the wage component (2.7% YoY the same as the previous quarter), while in the public sector labour costs went down by 9.1% YoY (Figure 12).
- In January, headline inflation (IPCA) accelerated four tenths to 0.7% YoY, mainly due to the core part of the rate, which increased significantly to 1.0% YoY, after +0.5% YoY in December (Figures 13 and 14). Low commodity prices, coupled with the expected moderation in private consumption over this year and

next will be the main factors behind the evolution of inflation over the forecast horizon, we expect it to be on average 0.9% in 2016 and 1.5% in 2017.

- For the first quarter of 2016, although with information still limited to confidence data, our MICA-BBVA model suggests that the economy may be growing at a slightly higher rate, about 0.3% QoQ (Figure 2). The slowdown observed in the second half of 2015 contrasts with our forecast of three months ago of a somewhat higher rate of recovery, so that now the growth for the whole of 2015 would have been 1.4%, 0.1pp less than in our estimate from November.

Growth forecast: without changes

- During the past few months, the main factors that underlie growth have been maintained (low commodity prices, accommodative monetary policy[1], lower fiscal adjustment) and they will continue to be supportive, but there has been a further deterioration in the global environment and a strong increase in political uncertainty nationwide. Therefore, we expect a slowdown in exports, which in turn will hinder investment decisions in a context of subdued domestic demand and increased uncertainty.
- Low inflation and the improvement in the labour market will continue to sustain household consumption, although somewhat more moderately after the strong growth of 2015, as the positive effect of some supporting factors will fade away.
- With regard to fiscal policy, we expect it to be somewhat contractive after the announcement of the government of further measures in order to comply with the Commission requirements. As a result, the contribution to growth of domestic demand will moderate to 1.4pp, after 2.3pp in 2015.
- Although we now expect further moderation in imports, they will grow more than sales abroad, meaning that net exports should have a slightly negative contribution over the forecast horizon.
- Overall, for 2016, we continue to expect the recovery to consolidate with a moderate and relatively stable quarterly growth that will result in an average annual growth of around 1.3%, unchanged from our forecast three months ago. Our first forecast for 2017 reflects better performance regarding domestic demand, especially in investment, which is expected to grow at a robust pace (4.5% after the 1.8% forecast for this year), while the parallel increase in exports and imports should end up in a slightly negative contribution. All in all, we anticipate GDP rising by 1.6% in 2017.

Fiscal policy and budget approval

- The budget for 2016 has just been approved in the parliament – although the final vote will be held on 16 March after the amendments deadline – after discussions with the European Commission on the project that they presented at the beginning of the year. The main discrepancies focused on the optimism of the economic scenario as it was presented then and, mainly, on the treatment of the temporary measures in determining the fiscal effort. By not complying with the correction of the excessive deficit in 2015, Portugal is also subject to the preventive arm of the Stability and Growth Pact and the rule of debt reduction from 2016, so that, based on the calculations of the European Commission (the July 2015 recommendation), the fiscal adjustment needed should be about 0.6pp of GDP this year, in contrast with the Commission's first assessment (with a fiscal deterioration of the structural component and a significant deviation from the recommendation).
- The government announced further measures in early February totalling around 1.1 million euros in 2016 (0.6% of GDP), focusing mainly on the revenue side (excise, vehicles, tobacco, contributions from banks to the Resolution Fund, and the removal of reduced social security on low wages and the exemption

1: For more information, see Europe Economic Outlook 1Q16 from some taxes on investment and pension funds and new taxes for the revaluation of company assets) and much less in expenses (procurement and more controls and monitoring of Social Security). Of these new measures, some 845 million euros would correspond to structural measures (0.5% of GDP) and partly offset the reversal of previous consolidation measures. As a result, the EC estimated that the fiscal effort reflected in the budget would be between 0.1pp and 0.2pp of GDP, so that the deviation from the recommendation in July last year would not be significant and so accepted the budget.

- Therefore, the budget for 2016 foresees a reduction in the deficit to 2.2% GDP from 4.3% in 2015, which would be the result of a fiscal effort of around 0.3pp of GDP (according to the government), the expected improvement in the cyclical part (of around 0.7pp of GDP) and the disappearance of the temporary effect of the capital injection to Banif (around 1.1pp of GDP).
- However, risks of deviation are high, especially since the government's economic prospects remain, in our view, optimistic (despite the government having lowered them to 1.8%, our forecast is 1.3%) while increasing financial stress could end up weighing on interest payment on debt. According to our forecasts, a more moderate cyclical improvement in public accounts (around 0.4pp of GDP) and increased interest payments of about one-tenth may bring the deficit this year to around 2.6% of GDP.

Portugal

National accounts: disappointing growth in 4Q15 (0.2% QoQ)

The slight growth in GDP is mainly due to the recovery of net external demand, the result of a sharp increase in exports of goods and services. On the other hand, the fall in investment has hindered domestic demand. Our MICA BBVA model, with very few indicators available for 1Q16, suggests that the economy would only marginally move forward (0.3% QoQ).

Figure 1
GDP (% QoQ) and breakdown by component (pp)*

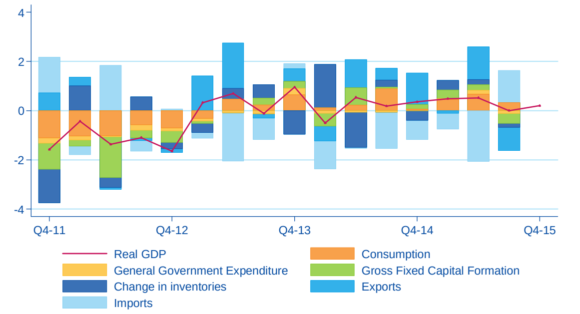
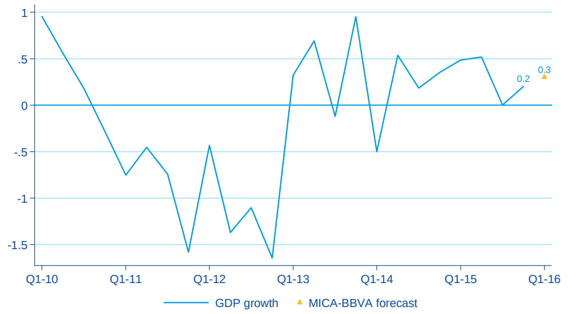


Figure 2
MICA-BBVA: GDP growth and forecasts (% QoQ)*



Confidence: the index of economic sentiment, stable in 4Q15

According to the ESI, business confidence remained virtually stable in 4Q15 above its historical average. By components, confidence in manufacturing is improving, while it is falling in the services sector and among consumers.

Figure 3
Confidence (ESI) and coincident activity indicator *

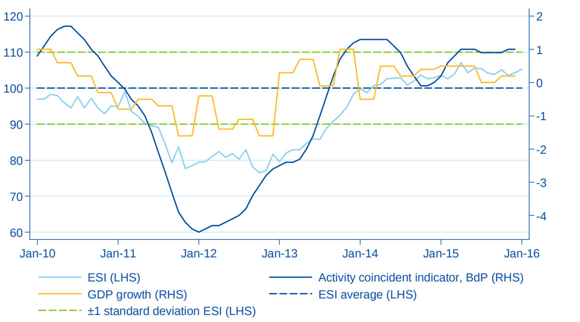
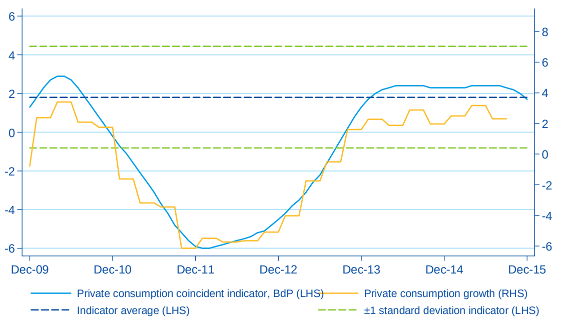


Figure 4
Coincident consumption indicator and private consumption (% YoY)*



Activity: industrial production and retail sales fall

Industrial production fell 0.6% QoQ compared to the 3Q15 average, when it fell 0.2% QoQ. Similarly, retail trade recorded a fall of 2% in the fourth quarter of 2015 as a whole.

Figure 5
Industrial production (% YoY) and industrial confidence*

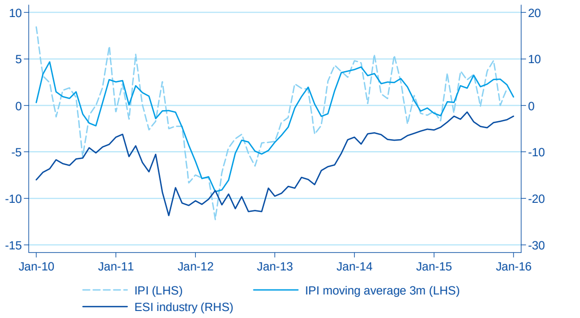
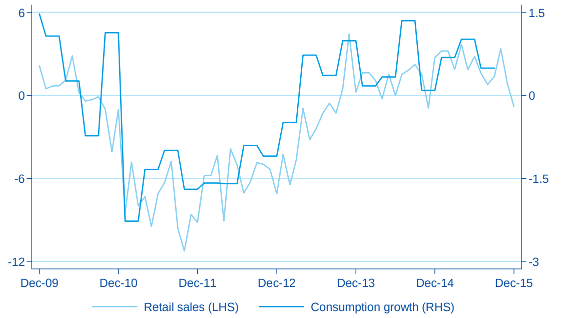


Figure 6
Retail sales (%YoY) and private consumption (%QoQ)*



* Sources: HAVER and BBVA Research

External sector: the lower global demand continued to affect goods exports

Despite moderating their fall, exports fell 0.2% QoQ in 4Q15. On the other hand, imports continued to decline (-0.9% QoQ), after the collapse already registered in 3Q15 (-5.5% QoQ).

Figure 7
Exports and imports (% YoY, 3p moving average) *

Figure 8
Exports (% YoY) and export orders*

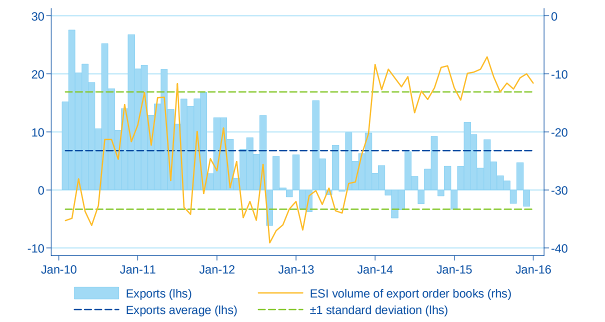


Figure 9
International trade by destination (% YoY, sa)*

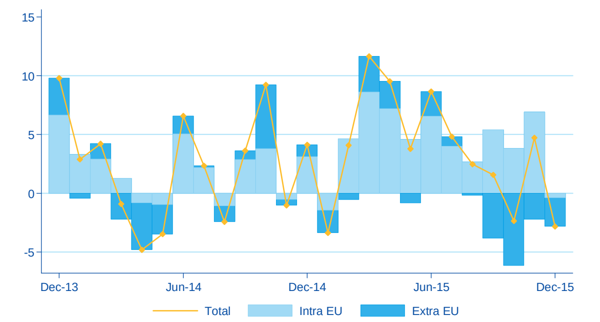
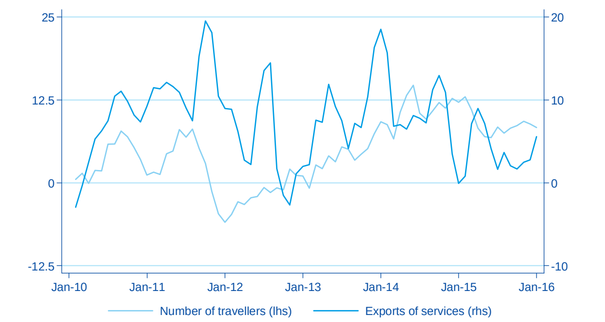


Figure 10
Tourism and services exp. (% YoY, 3p mov. avg.) *



Labour market: the reduction in unemployment continues

The unemployment rate continued to decline in 4Q15, registering 11.8% in December, thanks to the possible acceleration in the creation of employment after the moderation of 3Q15. Regarding private wages, they are increasing at a stable pace (2.7% YoY in 3Q15)

Figure 11
Unemployment rate (%) and employment expectations*

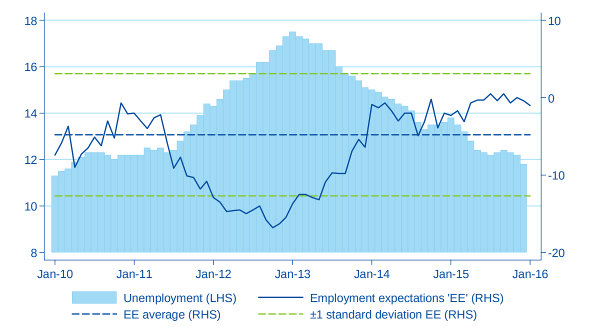
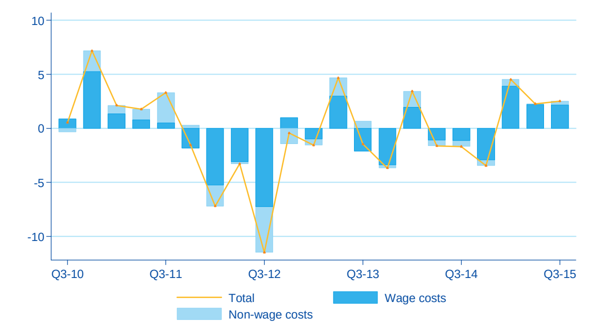


Figure 12
Labour costs in the business sector (% YoY)*



* Sources: HAVER and BBVA Research

Prices: headline and core inflation accelerated in January

In January, headline inflation (IPCA) accelerated 0.4pp to 0.7% YoY, mainly due to the core part of the rate, which has increased significantly to 1.0% YoY, after being at +0.5% YoY in December.

Figure 13
Inflation: headline and core (% YoY)*

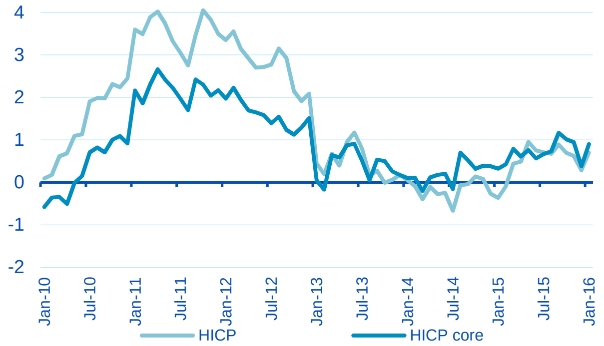
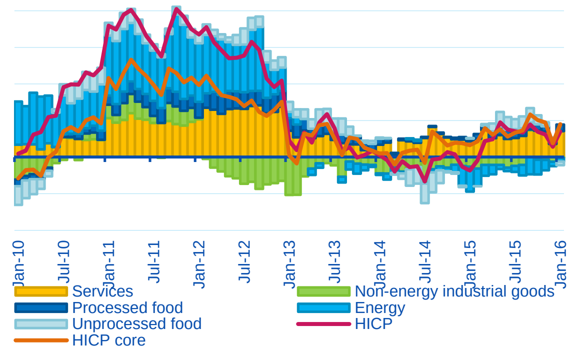


Figure 14
Inflation by component (contribution in %)*



Public Sector: deficit reduction, but with non-compliance risks

According to our forecasts, a cyclical improvement in public accounts (about 0.4pp of GDP) and increased interest payments of about one-tenth may bring down the deficit this year to about 2.6% of GDP.

Figure 15
Fiscal expenditure (compared to previous year)*

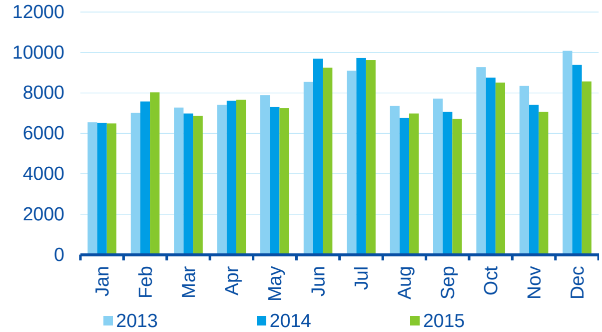


Figure 16
Fiscal revenues (compared to previous year)*

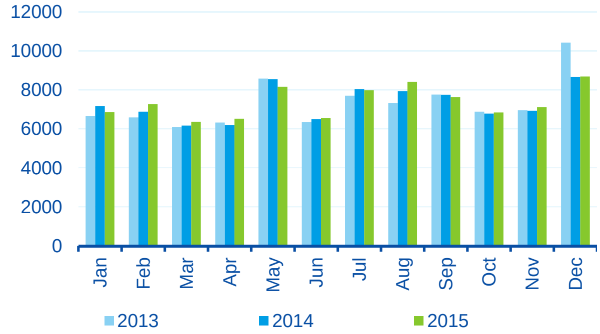


Figure 17
Public and private debt (% of GDP)*

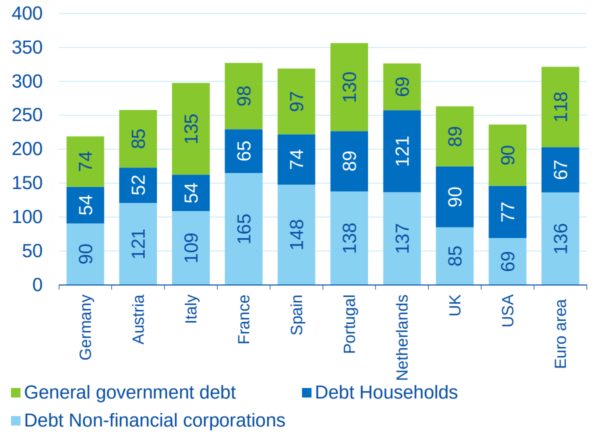
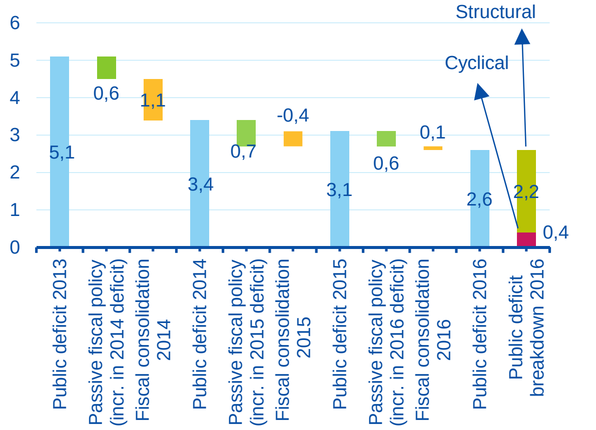


Figure 18
Breakdown of fiscal deficit (cyclical and structural)**



* Sources: HAVER and BBVA Research

** Sources: HAVER and BBVA Research, excluding one-offs

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