ECONOMIC ANALYSIS

Portugal: the forecast of a moderate recovery remains

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The weakness of the recovery has extended to the beginning of the year because of the deterioration in some external factors. Despite the economy performing slightly worse than expected, the growth forecast for 2016-17, of 1.4% and 1.6% respectively, remains unchanged, compared to three months ago, thanks to a gradual improvement in external demand, to less internal uncertainty and to new ECB measures

Recent developments

- According to National Accounts data, **GDP grew 0.1% QoQ in 1Q16, below what was foreseen by our short term model** (MICA-BBVA: 0.3% QoQ; Consensus: 0.4% QoQ), **which means that the weakness of the recovery has continued from mid 2015 to early 2016**. Although detailed results of the composition of GDP have not been provided, the available data suggests that **this weak growth continues to be supported by private consumption, while investment has fallen again**, weighed down by uncertainty **and**, above all, by the fall in **exports**.
- Despite the decline in March, **retail sales bounced back in January and February,** to somewhat more than 4% above the 4Q15 average (when they fell -2% QoQ), which means rates above even those observed at the beginning of 2015 when private consumption was moving along at a rate of almost 1% QoQ. On the other hand, **industrial production is still not showing clear signs of recovery**, once again falling in March after rising earlier this year, so that in the first quarter it fell about 1% compared to 4Q15. Only the production of consumer goods increased, while capital goods decreased again and intermediate goods remained stagnated. **Finally, trade balance data to February shows an intensification in the fall in exports** at a somewhat higher rate than that experienced by imports. Thus, the positive contribution (quarterly) of net exports to growth could have been reduced somewhat.
- **Since mid 2015 there has been a clear slowdown in the rate of improvement in the labour market,** with the unemployment rate stabilised at around 12.3% (after falling from just over 17% in early 2013) **mainly due to stagnating employment** during the second half of the year. T**he slight reduction in the unemployment rate at just over 0.1pp to 12.1% in 1Q16 was due to a further decline in the labour force rather than to an increase in employment.** This more gradual improvement should continue in the coming months encouraged by very modest growth. Slightly more worrying is the **increase in unit labour costs in 2015** (1.6%, one tenth more than in the euro zone) that could signal the end of the gains in competitiveness of the Portuguese economy **in a context of weak global demand**.
- **The economic sentiment index** of the European Commission remained stable in 1Q16, above the historical average and **clearly improved in April, driven by improved expectations in the services sector** and, to a lesser extent in industry, which is continuing to reflect doubts about improving expectations regarding orders from abroad.
- Our **MICA-BBVA model, with still very little data for the second quarter, estimates GDP growth rates could remain at around 0.4% QoQ in 2Q16**.

Unchanged forecasts in 2016-17

- **During the past three months** there has been a **slight worsening of some of the global factors** underlying growth, such as lower support for raw material prices and a more highly valued euro, as well as restraint in overseas orders, although more recent data suggests that risks of a sharp slowdown in global demand are limited. **Domestically, although the uncertainty surrounding economic policy remains significant, it has been somewhat reduced** after the approval of the budget for 2016 and maintaining the sovereign debt rating, **and should benefit from the new extraordinary ECB measures** to boost credit and help mitigate the problems associated with the banking system. For all these reasons, **we maintain the forecasts of GDP growth at 1.4% for 2016 and 1.6% for 2017**, which implies **modest and relatively stable growth, although more balanced,** with net exports having a lesser effect on holding back activity, together with a moderation of the contribution of domestic demand (Table 1).
- **Private consumption should lose steam in 2016 and 2017 due to higher indirect taxes and the expected upturn in inflation, on the one hand, but also because of a much more moderate labour market improvement**. However, it could continue to grow by 1.7% in 2016 and 1.5% in 2017, as a result of the continuation of some short-term measures to boost lower incomes as well as the increase in the minimum wage. **A more moderate growth in investment is expected in 2016** (2.1% after almost 4% in 2015), mainly because of the significant fall in investment in machinery and capital goods in the second half of last year, and because external demand is still weak. **By 2017 we expect the increase in investment to gain momentum up to almost 4%**, supported by the gradual improvement in the global environment, and in the euro zone in particular, as well as by the easing of financing conditions. **Public consumption could moderate slightly due a somewhat contractionary fiscal policy** after the new measures proposed by the government. It announced fiscal tightening of around 0.3 pp of GDP which, coupled with the cyclical improvement and discounting *one-off* effects (about 1.2 pp in 2015), should reduce the deficit to -2.2% of GDP in 2016. Given our scenario of growth that is somewhat more moderate than that forecast by the government, we expect the deficit to be around -2.6% of GDP. And, despite greater resistance than in other countries in the euro zone, exports will suffer from lower global demand and grow somewhat less than imports, so that **net exports could take away some growth in 2016-17, but not nearly as much as they did in 2014-15.**
- Low oil prices along with a moderation in private consumption will be the main factors responsible for the **low inflation** that we expect, **on average 0.5% for 2016, slightly higher than in the euro zone due to increased indirect taxes**, and it will increase to 1.3% in 2017.

Portugal

National accounts: the weakness of the recovery extends to 1Q16 (0.1% QoQ)

Weak growth may have continued, supported by private and public consumption, while exports may have fallen, which would also have hampered investment. Our model MICA BBVA estimates that the growth of GDP could gain some momentum until the 0.4% t/t in 2Q16.

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

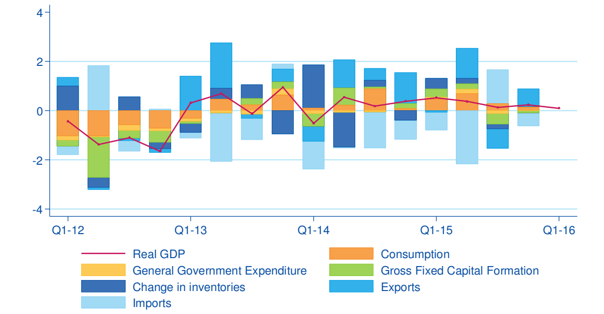
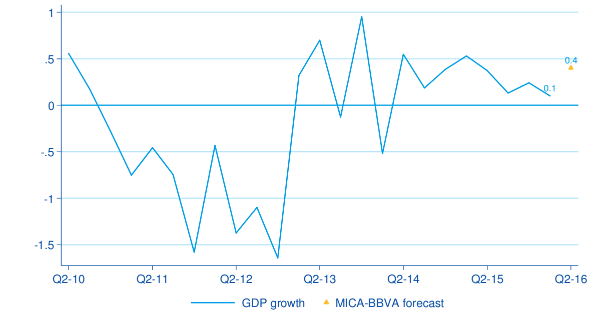


Figure 2
MICA-BBVA: Growth of GDP and forecasts (% QoQ)*



Confidence: stable in 1Q16 and a clear improvement in April

According to the ESI, business confidence remained stable in 1Q16 above its historical average. The improvement in April was driven by the services sector and contrasts with the deterioration in industrial confidence which has been attributed to lower external demand.

Figure 3
Confidence (ESI) and coincident indicator of activity*

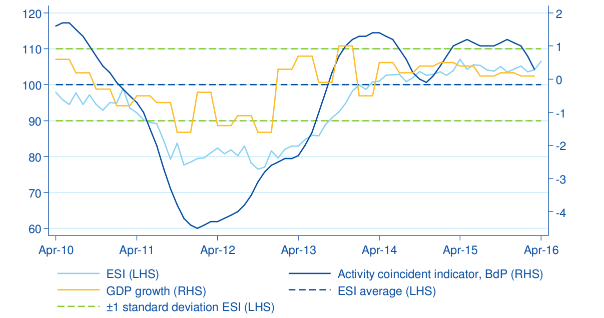
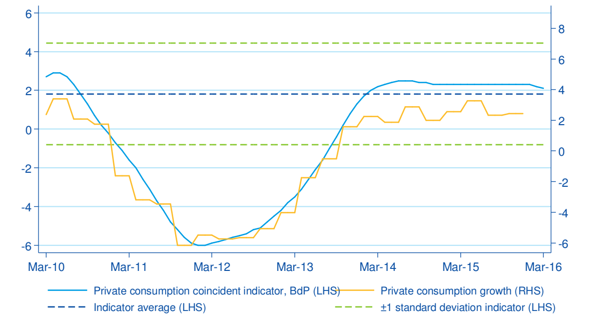


Figure 4
Coincident indicator of consumption & private cons. (% YoY)*



Activity: retail sales bounce back up, but industrial production falls in 1Q16

Industrial production fell 1% QoQ compared to the 4Q15 average, despite going up in January and February. In contrast, retail sales increased by somewhat more than 4% QoQ in 1Q16 and point to a robust growth in private consumption.

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

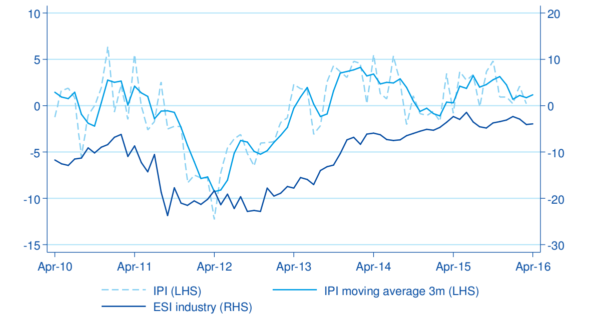
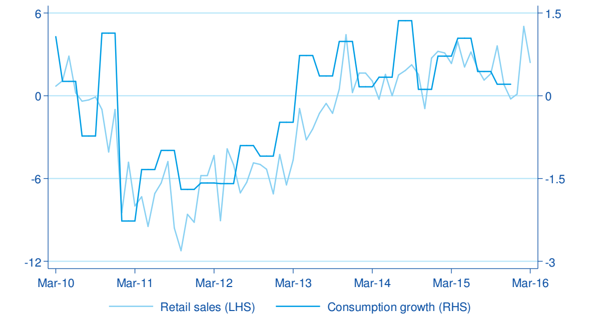


Figure 6
Retail sales (% YoY) and private consumption (% QoQ)*



* Sources: HAVER and BBVA Research

External sector: lower global demand continued to affect goods exports

Trade balance data to February points to an intensification in the fall of exports, falling at a higher pace than imports, so the positive contribution of net exports to growth could be somewhat reduced.

Figure 7
Exports and imports (% YoY, MM3p)*

Figure 8
Exports (% YoY) and export orders*

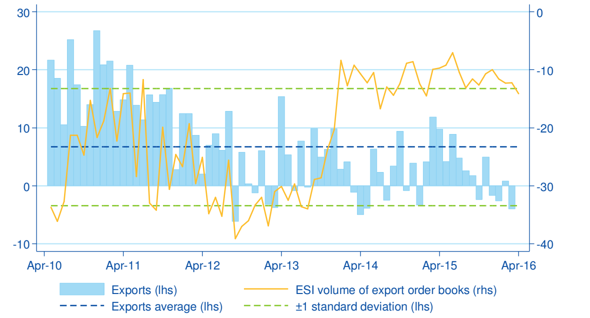


Figure 9
International trade by destination (% YoY, sa)*

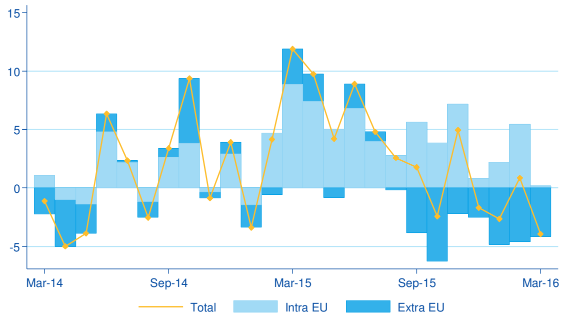
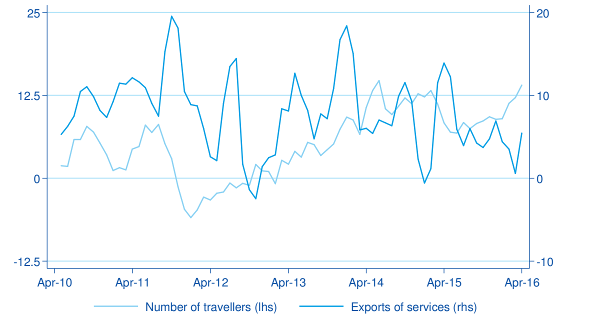


Figure 10
Tourism and export of services (% YoY, MM3p)*



Labour market: the improvement is slowed down because of weaknesses in job creation

The slight reduction in the unemployment rate at just over 0.1 pp to 12.1% in 1Q16 was due to a further decline in the labour force, after stagnating in the second semester of 2015. The increase in labour costs in 2015, although contained, could affect the competitiveness of the economy in a context of weak global demand.

Figure 11
Unemployment rate (%) and employment expectations*

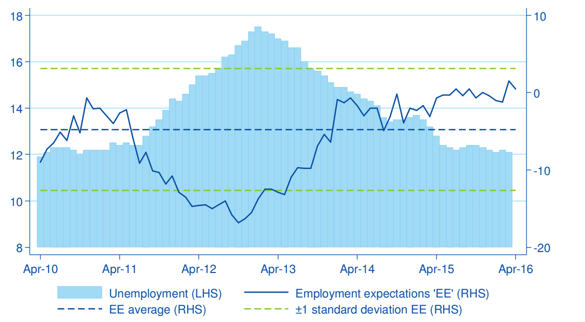
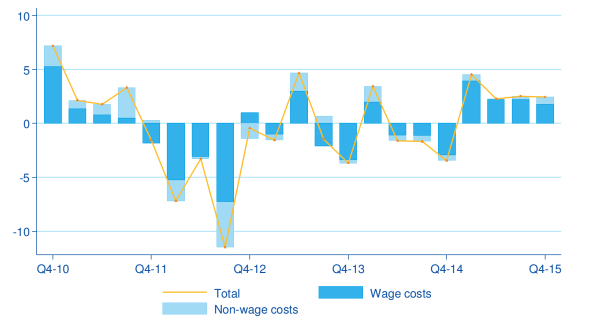


Figure 12
Labour costs in the business sector (% YoY)*



* Sources: HAVER and BBVA Research

Prices: headline and core inflation increased in March but both are still very low

In March, inflation accelerated by 0.3 pp to 0.5% YoY, due in particular to the rebound in the core component (1%) that reversed the fall in February and would in part have been due to the effect of a week early this year, and a smaller drop in prices of energy products. Discounting the volatility of recent months, headline inflation remains very low, fluctuating around 0.4% YoY from the end of 2015, and core inflation at around 0.8% YoY.

Figure 13
Headline and core inflation (% YoY)

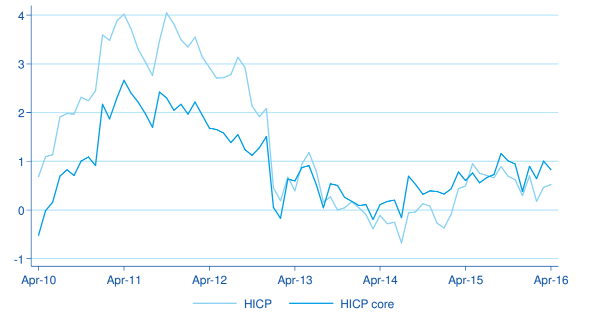
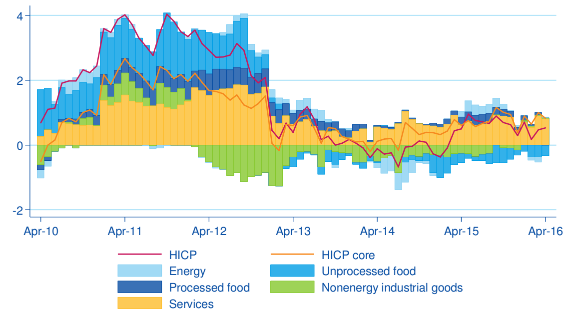


Figure 14
Inflation by components (inputs in %)*



Public sector: deficit reduction, but with default risks

The stability program includes a fiscal tightening of around 0.3 pp of GDP which, coupled with the cyclical improvement in the economy and discounting *one-off* effects (about 1.2 pp in 2015) would support reducing the deficit to 2.2% of GDP. Our scenario, less optimistic, suggests that the deficit might stand at 2.6% of GDP.

Figure 15
Tax expenditures (comparison previous year)*

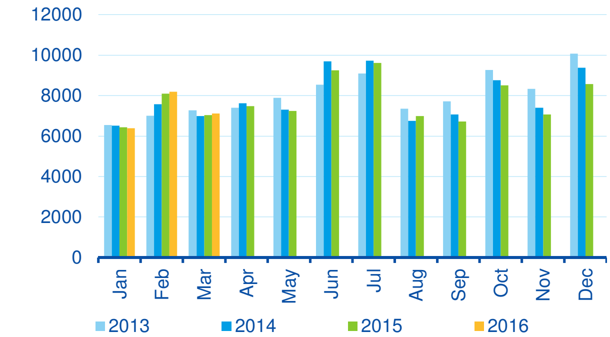


Figure 16
Tax revenue (comparison previous year)*

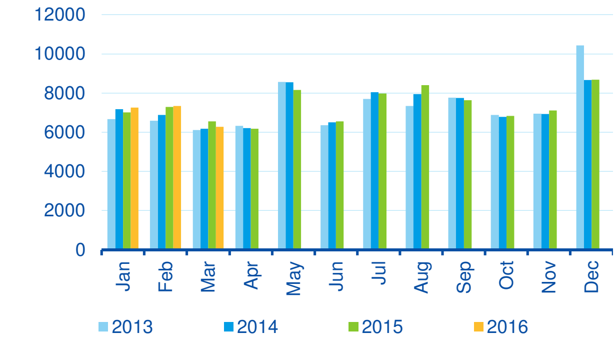


Figure 17
Public and private debt (% of GDP)*

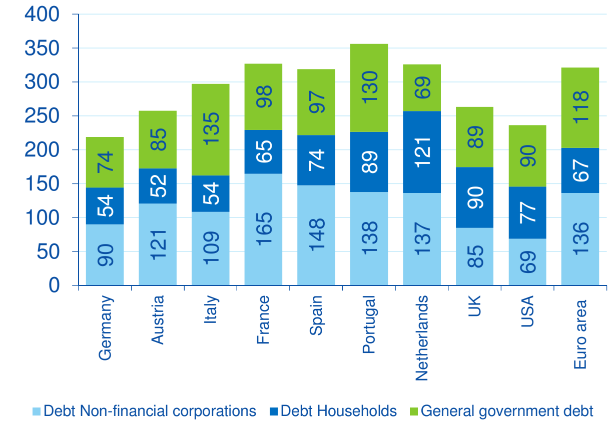
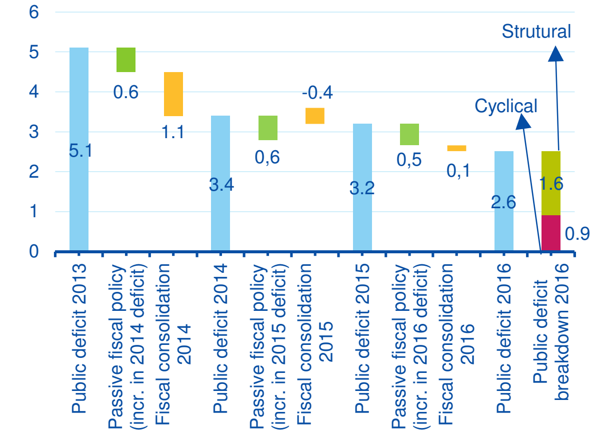


Figure 18
Breakdown of fiscal deficit (cyclical and structural)**



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

Table 1
Portugal: GDP growth forecasts and inflation

Annual growth (YoY)	2010	2011	2012	2013	2014	2015	2016	2017
Private consumption	2.4	-3.6	-5.5	-1.2	2.2	2.6	1.7	1.5
Public consumption	-1.3	-3.8	-3.3	-2.0	-0.5	0.6	0.3	0.1
Gross fixed capital formation	-0.9	-12.5	-16.6	-5.1	2.8	3.9	2.1	4.4
Inventories (*)	1.0	-0.6	-0.3	0.0	0.4	0.0	0.0	0.0
Domestic demand (*)	**2.1**	**-6.4**	**-7.6**	**-2.0**	**2.2**	**2.5**	**1.5**	**1.8**
Exports	9.5	7.0	3.4	7.0	3.9	5.2	2.9	4.4
Imports	7.8	-5.8	-6.3	4.7	7.2	7.4	3.1	4.6
Net exports (*)	**-0.2**	**4.6**	**3.6**	**0.8**	**-1.3**	**-1.0**	**-0.2**	**-0.2**
GDP	**1.9**	**-1.8**	**-4.0**	**-1.1**	**0.9**	**1.5**	**1.4**	**1.6**
Inflation	1.4	3.6	2.8	0.4	-0.2	0.5	0.5	1.3

(*) Contributions to growth.
Source: BBVA Research

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