ECONOMIC ANALYSIS

Portugal: GDP growth forecasts for 2018 reviewed upwards to 1.7%

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Growth of the Portuguese economy in 4Q16 reached 0.6% QoQ[1]**,** once again causing positive surprise (BBVA Research forecast 0.3% QoQ), albeit lower than that seen in the previous quarter (0.9% QoQ). As a result **Portugal ended 2016 with GDP growth of 1.4% YoY**, less than the 1.6% YoY posted in 2015, but **slightly more than the BBVA Research forecast** of mid-2016 (1.2%).

Based on data so far available, BBVA Research estimates that growth in 1Q17 will be around 0.2% QoQ, below that seen in previous quarters (see Figure 2). Despite this, **we expect Portugal's GDP to increase in 2017 by 1.7% YoY, more than forecast in November last** (1.3% YoY), in line with the positive bias anticipated in previous editions of this observatory. While it is perceived that some factors that have been supporting growth in domestic demand may prove transitory, if the recovery in investment is consolidated and exports continue to grow, the economy could continue to produce positive surprises. **Looking ahead towards 2018 we expect growth to hold at around 1.7% YoY**. Among the factors that will support the performance of the Portuguese economy during the next few quarters are for example a world environment that will favor the increase in sales of goods and services abroad. Also, some risks have had less impact than was previously estimated, specifically Brexit and uncertainty about economic policy. Apart from this, interest rates will continue at low levels, while fiscal policy is not expected to act as a drag on growth in domestic demand. In any case, doubts will remain about how solid the recovery in investment will be in an environment of high public and private indebtedness. Also, uncertainty persists about the restructuring of the Portuguese financial system. Lastly, it will be important to establish how sustainable the recent increases seen in household consumption are given households' low rate of savings.

Household consumption continues to recover

Domestic demand, after draining growth in 3Q16, **again contributed positively to economic activity in the last quarter of 2016** (1.6 pp contribution to quarterly growth relative to 3Q16, SWDA), almost tripling the average contribution made in the first half of the year (0.6 pp) (see Figure 1). The surprisingly good figures for private consumption and investment were the reasons for the good performance of domestic demand in the last three months of 2016. Despite this, the weakness shown by gross capital formation (GCF), especially during 1Q16 and 3Q16, explains why domestic demand **ended the year with a contribution of 1.5 pp to annual growth**, less than that observed in 2015 (2.6 pp).

1. Seasonally and working days adjusted (SWDA) data. All quarterly (QoQ) and monthly (MoM) changes in this document are calculated on the basis of SWDA data.

On the one hand, **private consumption improved faster in 4Q16** (1.2% QoQ, contributing 0.8 pp to the quarterly increase in GDP), with growth of 3.1% YoY, supported by the push from the demand that had been pent up during the crisis period, the reduction in uncertainty in the labor market given the growth of employment and an expansive monetary policy which cut interest rates and increased availability of credit (see Figure 5). This led to an average increase of 2.2% YoY for 2016 as a whole relative to 2015.

On the other hand, public consumption remains sluggish (0.5% YoY and 0.3% QoQ in 4Q), ending 2016 with a slight increase of 0.8% relative to 2015. This low growth rate in public consumption **is due in part to attainment of the deficit target in 2016.** In fact, according to budgetary execution figures, the cumulative deficit for the year was 2.3% of GDP, representing a reduction of 0.3 pp from the 2015 deficit (see Figure 6). **Although we do not yet know the amount of the public deficit in terms of the National Accounts, everything points to Portugal's finally having attained the target set for the whole year (2.5% of GDP) and it may even have reduced it by one or two tenths of a percentage point more**.

Uncertainty as to how investment will evolve

Investment is the component that best explains the change of direction in domestic demand relative to the previous quarter. After three falls of close to 2.9% QoQ in 3Q16, GCF increased by 5% QoQ in the last quarter of the year (2.6% YoY), contributing 0.8 pp to quarterly GDP growth. Investment in construction, and to a lesser extent in transport equipment, were the items contributing most to the recovery. In any case, given the volatility of the data and the rebound effect we might be seeing as a result of the weakness shown in the previous quarter, the improvement must still be treated with caution. In fact, despite the positive trends in the last quarter, investment ended 2016 with an average decline of 0.9% YoY. The uptick in investment could be related to the positive trend seen in the manufacturing sector (see Figure 4). **Despite this, the uncertainty that the productive sector continues to face is reflected in the decline in new lending to businesses** (see Figure 5).

Imports are regaining their dynamism and offsetting the good performance of exports

Net external demand once again contributed negatively to growth in 4Q16, following the positive surprise of the previous quarter. After contributing 1.2 pp to quarterly GDP growth in 3Q16, the external sector drained 1 pp from growth in the last quarter of the year (see Figure 1). **The recovery of imports** (4.5% QoQ and 7.4% YoY in 4Q) **confirmed the passing nature of the fall seen in 3Q16,** offsetting the **positive trend in exports.** Export sales of Portuguese goods and services increased at a rate of nearly 2.5% QoQ (6.4% YoY). This represents 4.4% more exports and 4.4% more imports on average in 2016 than in 2015, and a slightly negative contribution of external demand to average growth for the year (0.1 pp).

Employment is slowing, although it continues to increase at a lively pace

Published data for 4Q16 slightly reduce the improvement observed in 3Q16. Specifically, following the growth of 0.9% QoQ during the third quarter of the year, in 4Q16 the number of people in employment increased by 0.6% QoQ (1.8% YoY), keeping the number above 4.6 million. In this case, while services and the primary sector employed fewer people than in the previous quarter, industry and the construction sector contributed equally to the growth in employment in the last quarter of the year, relative to 3Q16 (SWDA).

1Q17: growth could revert to 0.2% QoQ

Initial data for January show a slight slowing in private consumption to rates somewhat less than those seen in the last quarter of 2016 and a stabilization of investment (see Figure 3). In the case of retail sales, data for January show growth of 2% YoY (compared with 4.3% YoY on average between October and December). Industrial Production Index, which continued to increase during 4Q16, posted an increase of 2.7% YoY in January, less than the uptick of December (4.3% YoY), but more than the average annual growth seen between October and December (2% YoY average for the three months).

Apart from this, both the **Coincident Activity Indicator and the Coincident Consumption Indicator**[2] for January show **slight improvement** relative to the last few months of 2016. Specifically, January saw growth of 1.2% YoY and 2.5% YoY in the Coincident Indicators of Activity and Consumption respectively (compared with average growth of 0.9% YoY and 2.3% YoY respectively between October and December). The **Economic Sentiment Indicator (ESI)** published by the European Commission **continued the upward trend** already seen towards the end of last year and between January and February it increased slightly to an average of 110 points, from the average of 108.6 points in the last three months of 2016. The same signal is sent by the first employment data of the year, with growth maintained at 0.4% MoM for the second month in a row.

Lastly, **monthly employment data show growth of 0.5% YoY in January,** stabilising the advances observed between October and December (average 0.6% YoY). **This implies a decline in employment of 0.2% MoM (SWDA) relative to December.**

Thus, even though available indicators generally show positive advances, the imbalances that persist and the sustainability of the growth seen in both domestic demand and investment continue to raise doubts about the rate of recovery of economic activity in Portugal. And so, considering the increases in private consumption and investment in 4Q16 to be temporary, **GDP growth could be around 0.2% QoQ before gaining in dynamism over the course of the year with rates closer to 0.4% QoQ.** This trend, together with the upward revision of the estimate for 2016, **brings the forecast for 2017 up to 1.7%** YoY (from the previous 1.3%), confirming the positive bias anticipated in the last few editions. As in 2017, **growth in 2018 (which**

2. Indicators published by Banco de Portugal, summarising the most significant information on the country's economic activity and consumption.

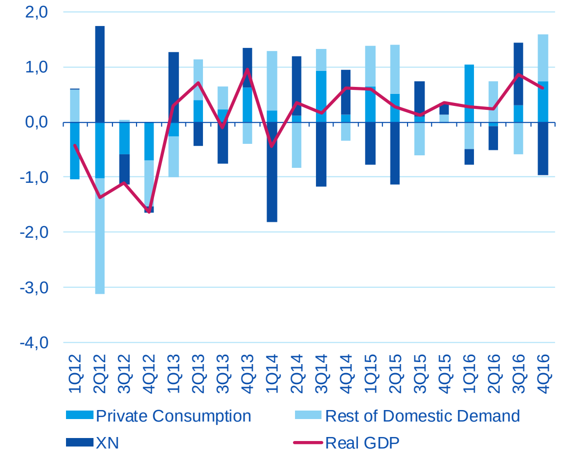
would again be at 1.7%), would be the result of domestic demand, which would contribute more than in 2016, and external demand which would increase its negative contribution.

On the one hand we expect **private consumption to remain dynamic over the course of 2017 and 2018**, supported by improved net wealth of households, the decline in uncertainty, the continuation of expansive monetary policy and a fiscal policy that should remain neutral or slightly contractive. Moreover, if the signs from investment are confirmed, **an environment of improving competitiveness of Portuguese companies could consolidate.** The foregoing, together with the positive growth expectations both in Europe and in the emerging markets bode well for a continuing environment of dynamism for the country's exports. Lastly, despite the expected recovery in exports, external demand will continue to drain growth, because of the increase in imports driven by the improvement in investment and private consumption.

Main indicators of activity

Figure 1

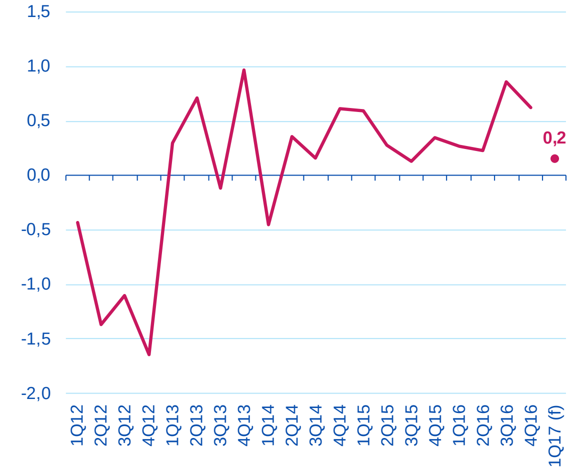
GDP (% QoQ) and contributions by component (pp)



Source: BBVA Research based on INE and BdP

Figure 2

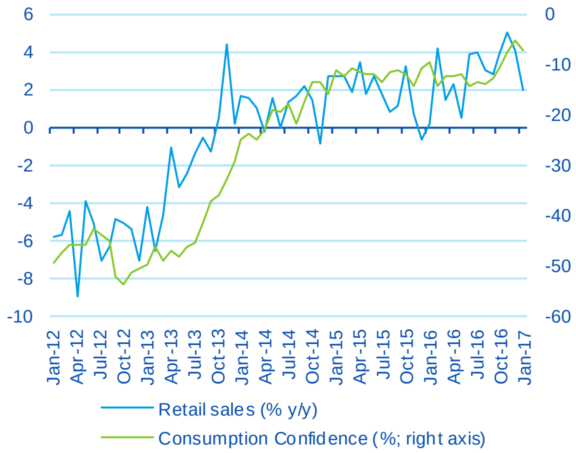
MICA-BBVA: GDP growth (% QoQ) and forecasts



Source: BBVA Research based on INE and BdP

Figure 3

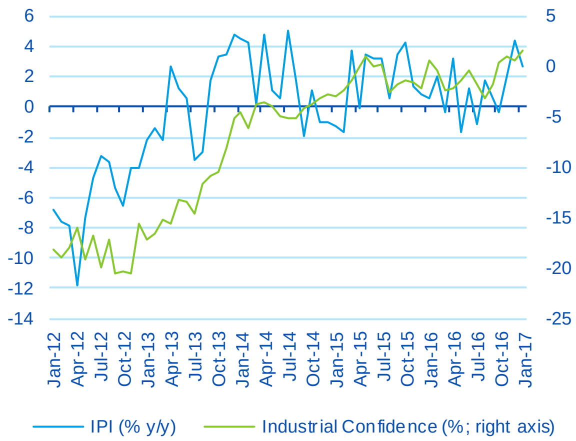
Indicators associated with consumption



Source: BBVA Research based on INE and BdP

Figure 4

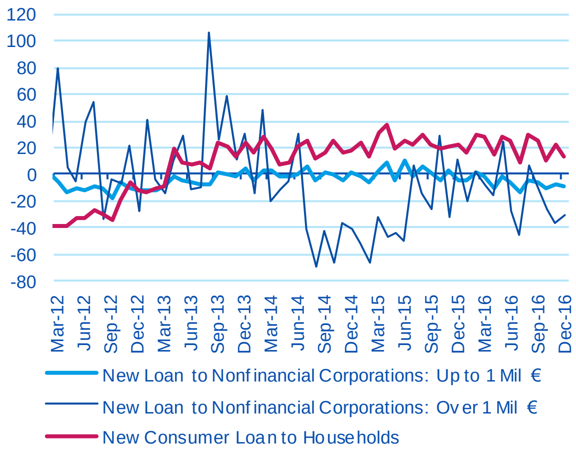
Indicators associated with industry



Source: BBVA Research based on INE and BdP

Figure 5

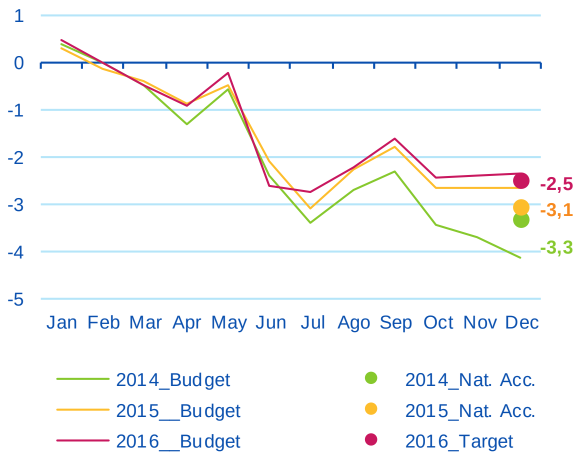
New loan to nonfinancial corporations and households (% YoY)



Source: BBVA Research based on INE and BdP

Figure 6

Fiscal Deficit: Budgetary execution and National Accounts (% GDP, Not including injections to the financial sector.)



Source: BBVA Research based on INE and BdP

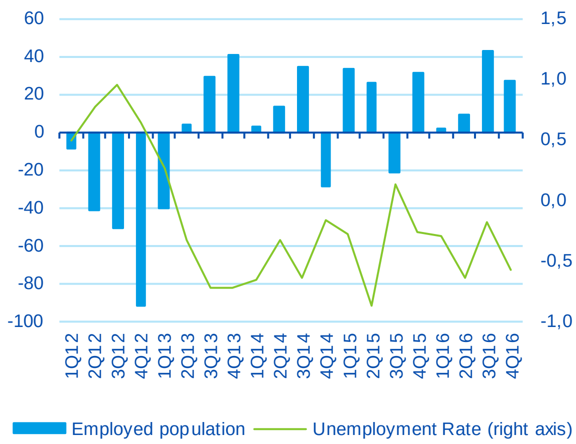
Figure 7

Indicators associated with the external sector (% YoY)

Source: BBVA Research based on INE and BdP

Figure 8

Population employed (quarterly change in thousands of persons) and unemployment rate (quarterly change in pp)



Source: BBVA Research based on INE and BdP

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