

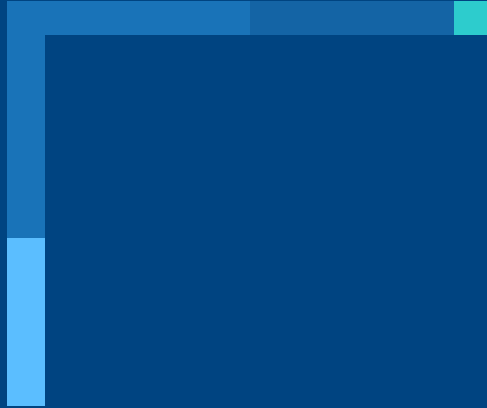
The logo for BBVA Research, featuring the word "BBVA" in a bold, white, sans-serif font, followed by the word "Research" in a smaller, lighter weight of the same font. A small teal square is positioned to the right of the word "Research".

**BBVA** Research

# Portugal economic outlook and its long-run challenges

Portugal, from Here to Where? **Lisbon, May 2019**

Creating Opportunities



# 01

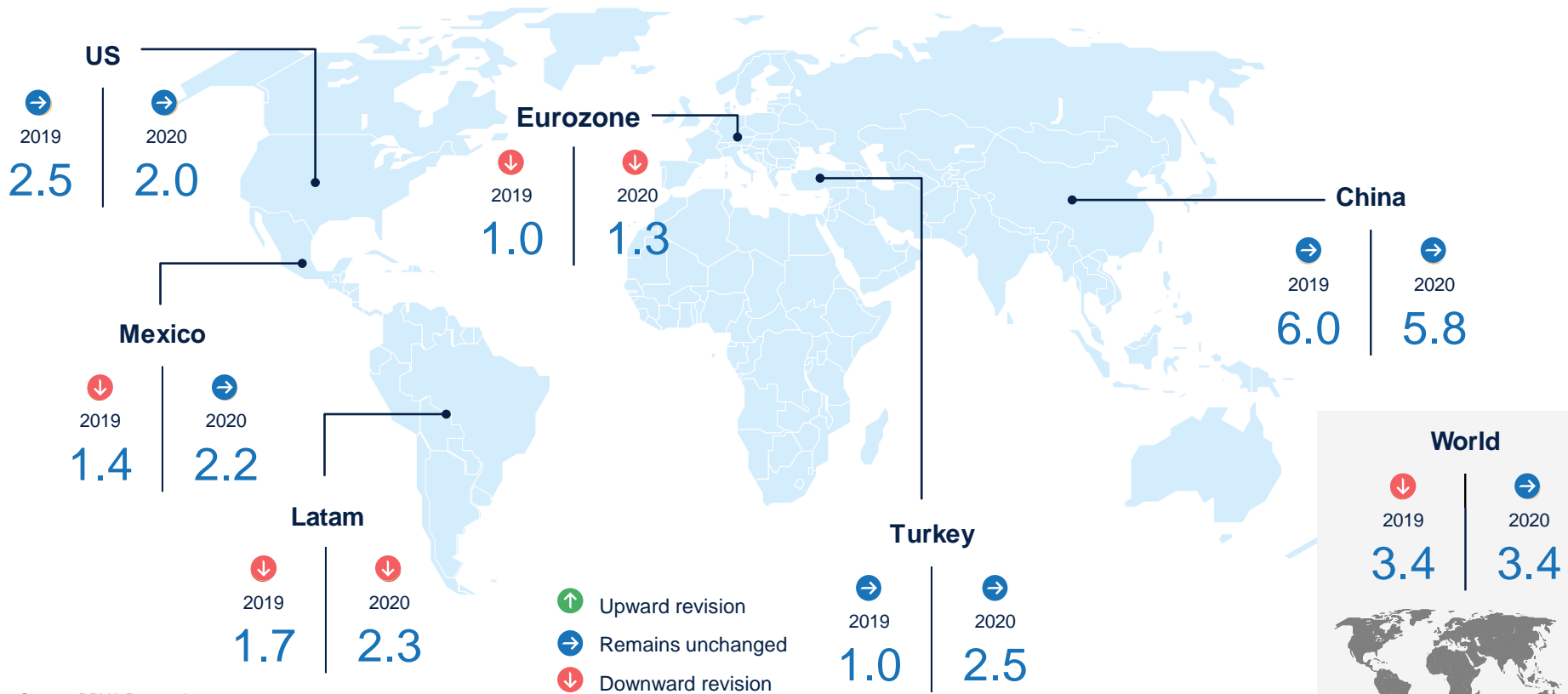
## Main takeaways

## Key messages



- Global activity remains weak and uncertain, leading to stabilizing economic policies, particularly by central banks, that seek to soften the slowdown in growth. However, trade tensions could derail global growth
- Our GDP growth forecast for Portugal has been revised downwards to 1.5% for 2019, due to lower European demand and increased uncertainty. Recovery will continue thanks to the stabilization of global growth, the support from monetary policy and domestic demand
- There are still numerous risks and, once that the cyclical recovery is almost complete, it is now necessary to think about the long-run challenges of the Portuguese economy, to continue the implementation of policies to reduce its vulnerabilities to changes in the global outlook and to take advantage of the opportunities of the digital revolution. Best policies will achieve better results in terms of higher employment and productivity, lower inequality and more sustainable growth

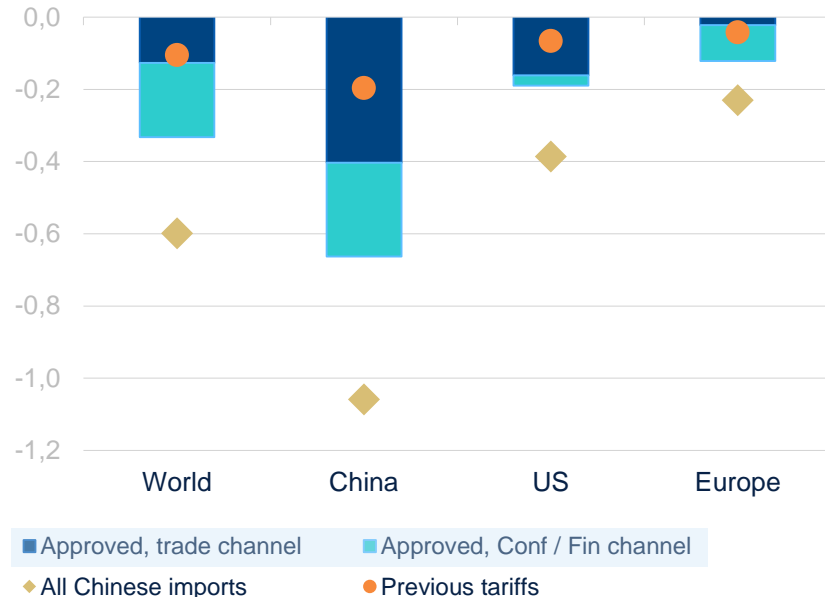
# Without “accidents” global growth will decelerate gradually, but trade tensions could derail this baseline scenario



# Protectionism: US-China trade tensions escalate and the EU gets a temporary respite from US auto tariffs

## Effect of approved US tariff increases and retaliation on GDP growth. May 2019

(Two years, pp)



Source: BBVA Research

- US increased tariffs from 10% to 25% on Chinese USD250bn imports on May 10th
- China has vowed to retaliate, although it has not specified how and when
- This increase in tariffs could have an impact on China's GDP growth of about 0.5pp to add to 0.2pp of measures already adopted. On the US and the Eurozone, the impact would be much lower
- US-China negotiation seems to remain open and agreement is still possible

# Growth expectations lowered amidst increased risk



# 2019-2020 Outlook: the economic recovery will continue



## Global demand could recover slightly if uncertainty goes down

Different risk events could be still resolved favorably supporting global recovery



## Expected fall of oil prices during the second half of the year

Production costs should benefit from lower transportation prices, while supporting household spending



## Monetary policy will continue to be expansionary

The Fed and the ECB will continue to support growth by keeping interest rates low for longer. A new round of TLTRO (targeted longer-term refinancing operations) will be launched in Europe and the exchange rate will be further depreciated



## Reduced risk premium

The Portuguese risk premium has been supported by rating decisions, commitment to deficit reduction and reforms, and the pursuit of profitability

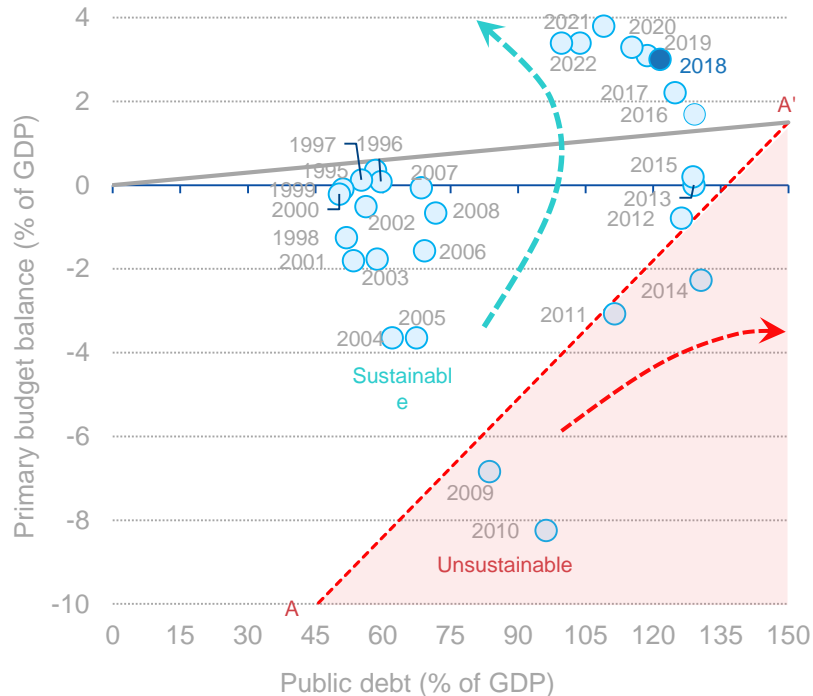


## Consolidation of an environment of low uncertainty at domestic level and improved public accounts

result in better financial conditions for firms, households and the public sector

# 2019-2020 Outlook: fiscal consolidation should continue

## Primary budget balance and public debt, 1995-2023

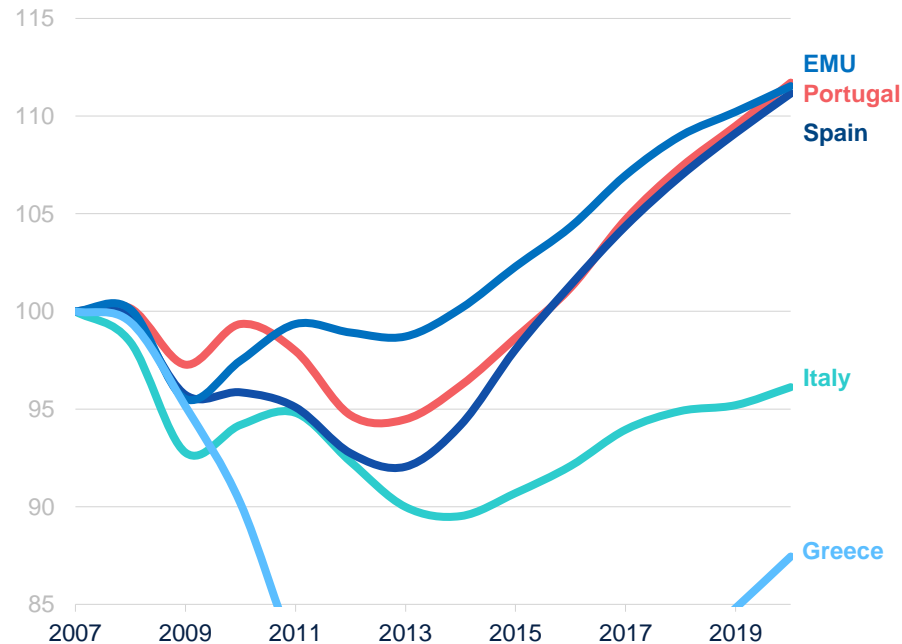


- Fiscal consolidation has contributed to improving the sustainability of public debt, which still remains very high
- This improvement in public finances has contributed to the reduction of the Portuguese risk premium and better financial conditions
- The primary budget balance should continue to be above 3% of GDP



# Portugal has surpassed pre-crisis income levels thanks to a favorable combination of external and internal factors

## GDP per working-age population, 2007-2020 (2007=100)

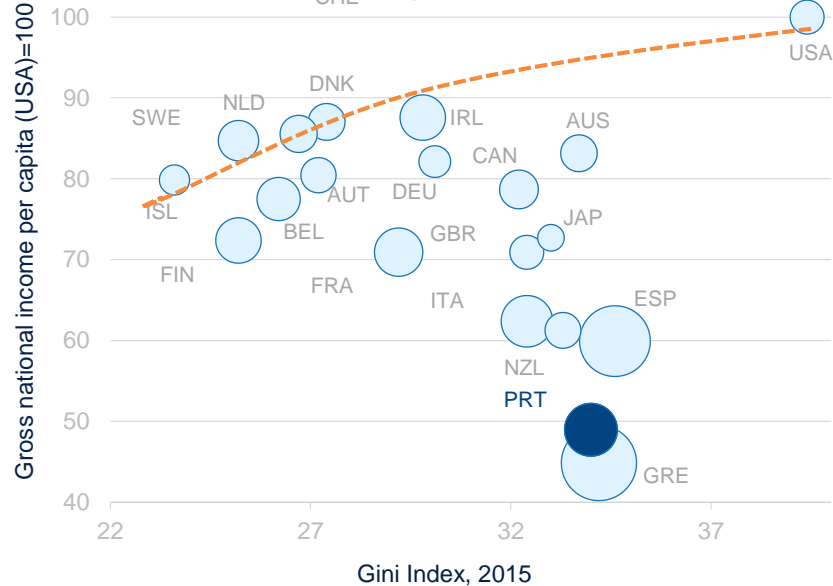


Source: BBVA Research and European Commission

- The recovery has been much more than the natural rebound from a very deep recession and external conditions
- A simple rebound after the crisis could explain differences with EMU but not with other countries, such as Italy and, more significantly, Greece
- Portugal and other countries such as Spain and Ireland have also benefited from structural reforms
- The unemployment rate is now below pre-crisis levels without overheating the economy, but the saving rate and productivity growth are low

# The long-run challenges of the Portuguese economy

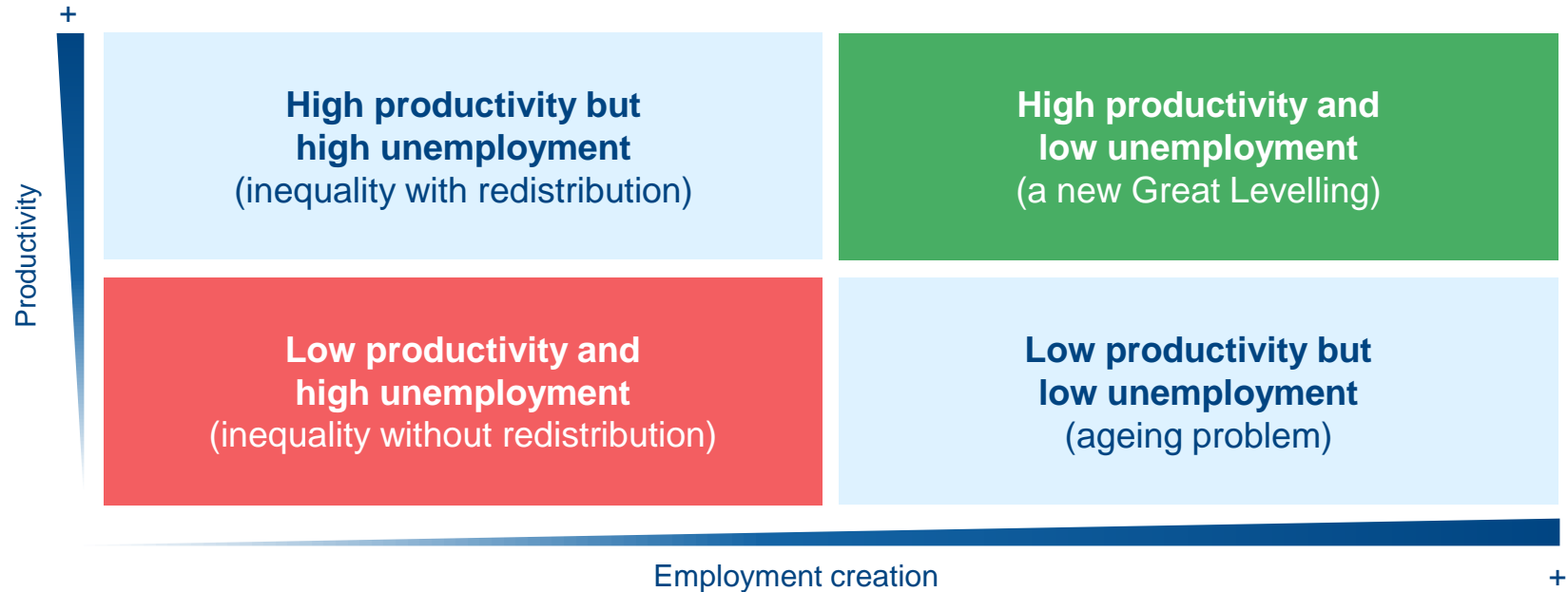
## Per capita income, inequality and unemployment OECD, 2016



Source: BBVA Research based on the OECD and Eurostat. The size of each circle is in proportion to unemployment

- Once that the cyclical recovery is almost complete, it is now necessary to think about the **long-run challenges of the Portuguese economy**
- The challenge is to **manage the technological and digital transformation** by increasing growth while reducing both inequality and the unemployment rate.
- Countries like **Portugal** are far from the frontier, allowing for higher-growth policy strategies that **increase productivity, do not raise unemployment and reduce inequality**

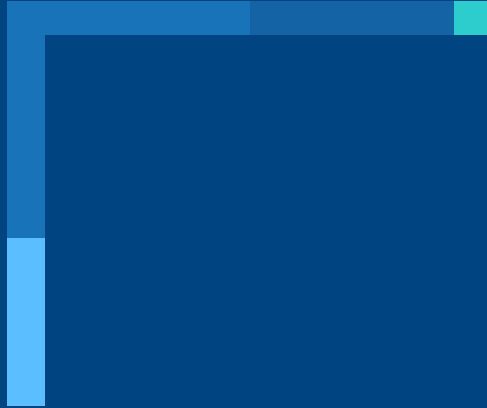
# The challenge of the digital revolution: winners or losers?



Countries may end up in very different scenarios, depending on how they manage the digital revolution, which is generating a new international division of labor and global wealth.  
**Best policies will achieve better results in terms of employment, productivity and inequality.**

# Reforms to take advantage of the digital revolution opportunities

1. A more efficient and equitable **labor market** in the digital age
2. Fiscal rules, budget stability and improved efficiency of the **public sector**
3. Sustainability and sufficiency of the **welfare state** in the face of an ageing population
4. More productive and bigger **firms**
5. Better **regulations** & business-friendly environment: attract productive external investment
6. Greater internationalization and **competitiveness**: better presence in global value chains
7. Better **institutions**
8. More **innovation** and technological capital
9. Better **human capital** to take advantage of the digital revolution
10. A more inclusive and sustainable growth with more **equality of opportunities**



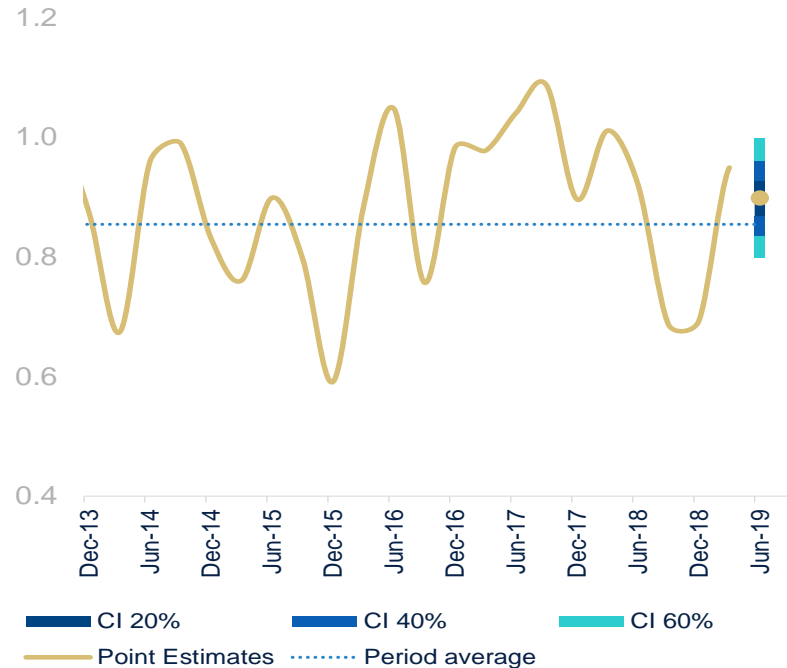
# 02

## Global Economic Outlook 2Q19

# Global GDP has moderated more than expected

## World GDP growth

(Forecasts based on BBVA-GAIN % QoQ)



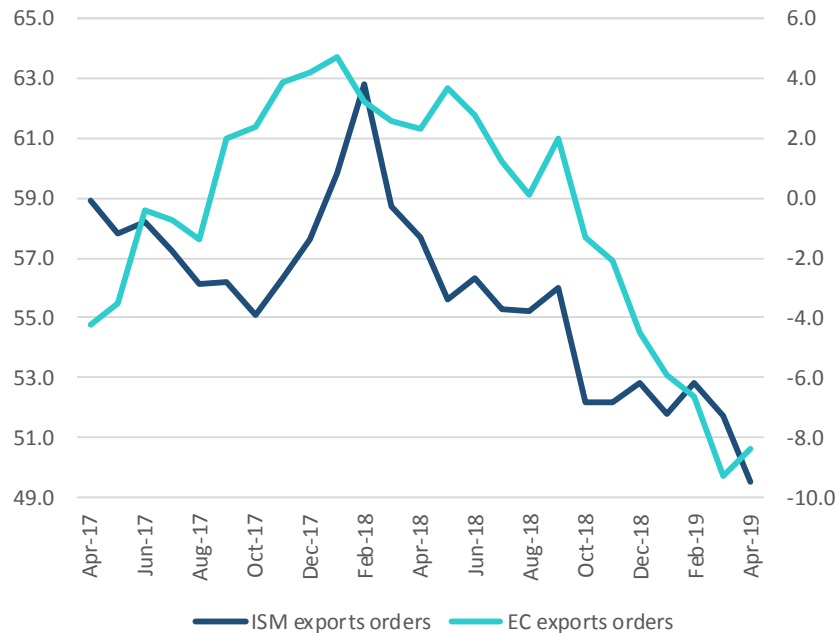
Source: BBVA Research

- Global growth has slowed due to China slowdown, high uncertainty in Europe, trade protectionism and the cyclical slowdown in the US
- A slight improvement is possible in the short run, but activity will remain less dynamic than in previous years

# Exports, PMI and IPI are weak but with some signs of stabilization

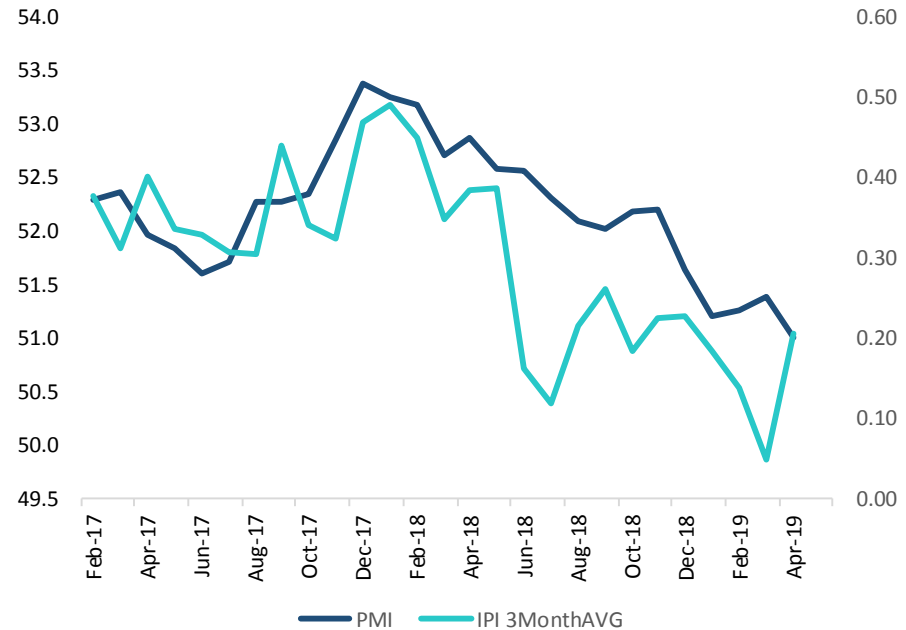
## World exports of goods

(Index, Dec-15=100)



## PMI and IPI

(Points, m/m %)



# Growth moderation has caused a shift in monetary policy in the US and the Eurozone, and new stimuli in China

## Fed

- Long pause in the rate hikes, but there could be a hike by the end of the year
- The normalization (reduction) of the balance sheet will end earlier than expected (September 2019)

## BCE

- Postponement of monetary normalization
- Lower interest rates for longer and additional liquidity

## China

- Additional monetary stimulus: RRR and lending rate reductions in 2019
- Increase in public deficit, to 2.8% of GDP in 2019
- Tax cuts (2% of GDP)

## Latam and other emerging countries

- There is room for a more dovish monetary policy



# ECB's increased caution: lower rates for longer and more liquidity



## Balance Sheet

- ▲ **End of QE** (December 2018)
- ▲ **Total QE reinvestment** after the beginning of interest rate's hiking cycle
- ▲ **New round of liquidity auctions (TLTRO III)** from September 2019 to March 2021, with a two-year maturity:
  - To avoid an abrupt adjustment of the financing of the banking sector
  - Less generous conditions than in previous rounds



## Interest Rates

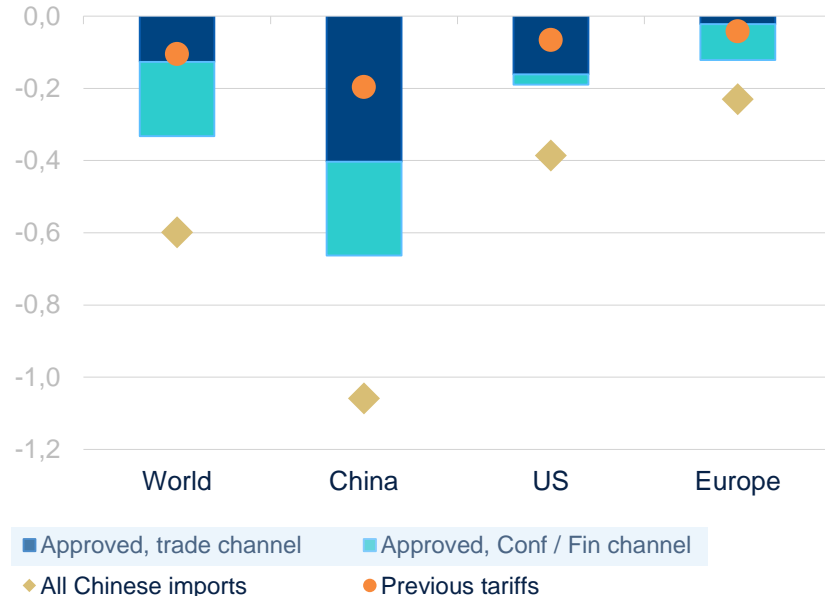
- ▲ **Low interest rate expectations reinforced** due to the economy's poorer performance and higher risks
- ▲ **No rate hikes expected until December 2020**



# Protectionism: US-China trade tensions escalate and the EU gets a temporary respite from US auto tariffs

## Effect of approved US tariff increases and retaliation on GDP growth. May 2019

(Two years, pp)



Source: BBVA Research

- US increased tariffs from 10% to 25% on Chinese USD250bn imports on May 10th
- China has vowed to retaliate, although it has not specified how and when
- This increase in tariffs could have an impact on China's GDP growth of about 0.5pp to add to 0.2pp of measures already adopted. On the US and the Eurozone, the impact would be much lower
- US-China negotiation seems to remain open

# Action by central banks and an absence of "accidents" would enable global growth to soft-land

More signs of global slowdown



New stimulus policies



Assumption on the evolution of the global outlook: no "accidents"



01  
**Protectionism**  
A US-China trade agreement is still possible



02  
**Brexit:**  
Greater uncertainty, for a longer time



03  
**Financial markets:**  
volatility constrained by central banks' measures

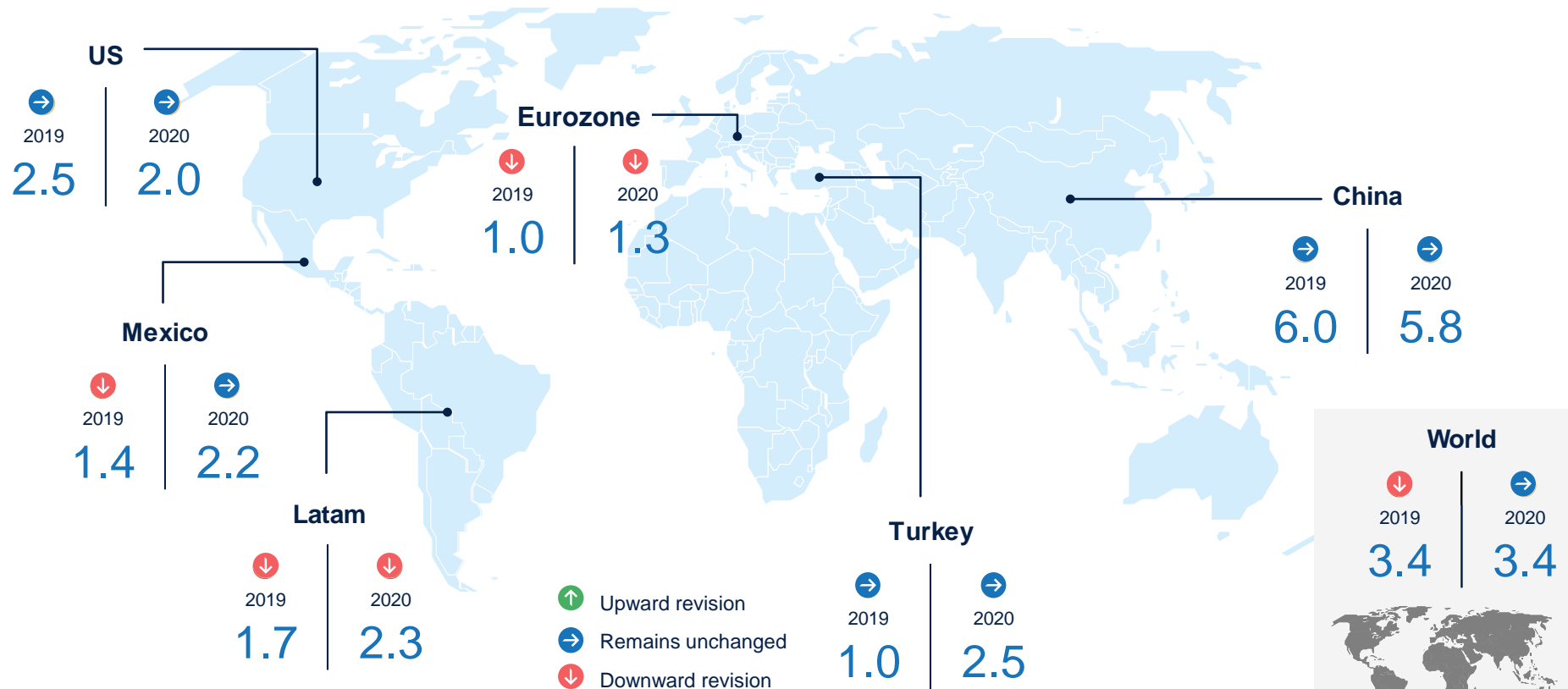


04  
**Oil:**  
Price moderation following the recent upturn



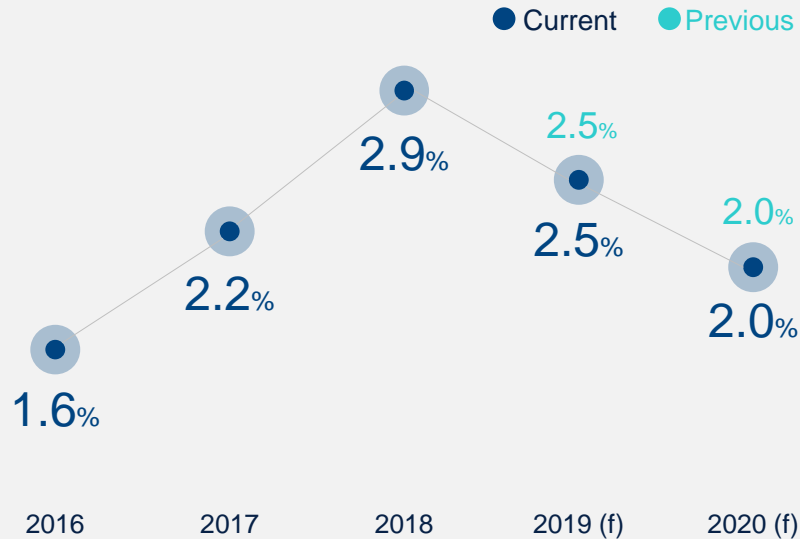
Global growth soft-lands

# Without “accidents” global growth will decelerate gradually, but trade tensions could derail this baseline scenario



# US: a cyclical activity moderation and a more patient Fed

## US: GDP growth (% YoY)

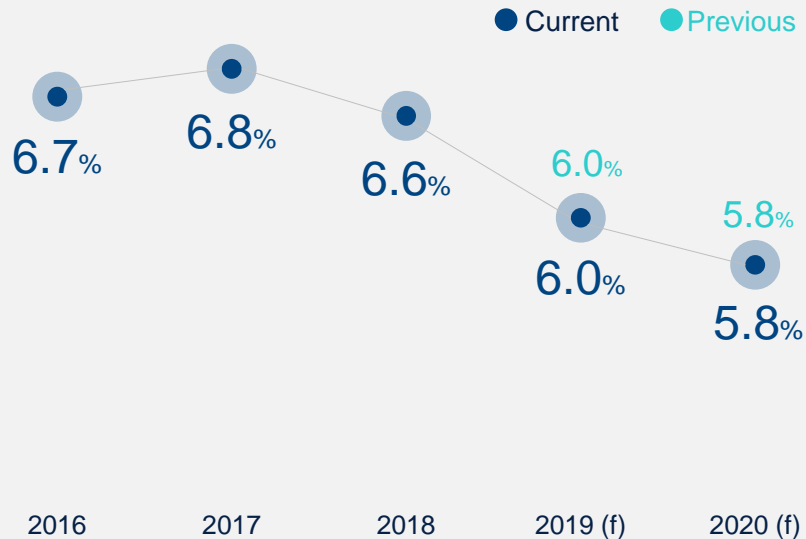


(f) Forecast.  
Source: BBVA Research

- Growth will continue to lose steam going forward, converging to the potential rate
- Unchanged growth forecasts (with a downward bias), while the risk of recession remains high
- Inflation is expected to continue below the 2% mark during 2019

# China: a trade agreement with the US and more expansionary policies will lead to a soft landing

## China: GDP growth (% YoY)

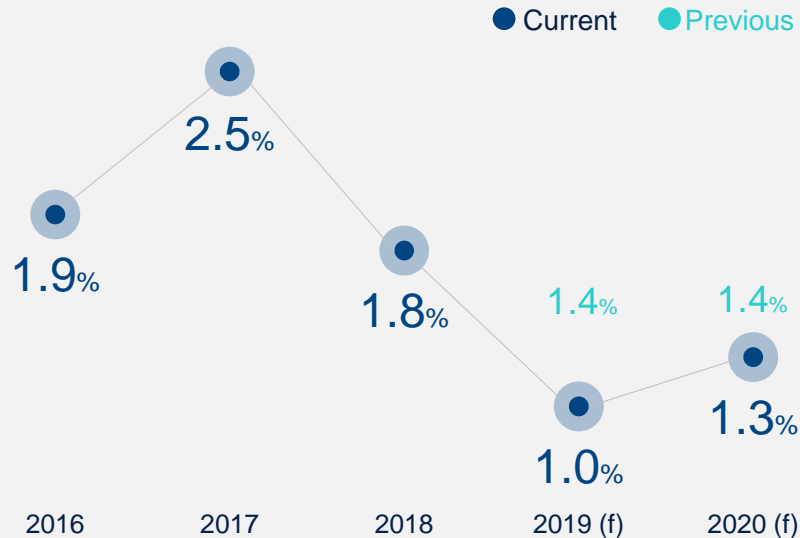


(f) Forecast.  
Source: BBVA Research based on BEA

- The growth target for 2019 was reduced to a 6.0%-6.5% range
- A sharp slowdown in growth remains an important risk
- **Monetary stimulus:** cuts in bank reference rates and RRR's
- **Fiscal stimulus:** VAT-centered tax cuts of 2% of GDP

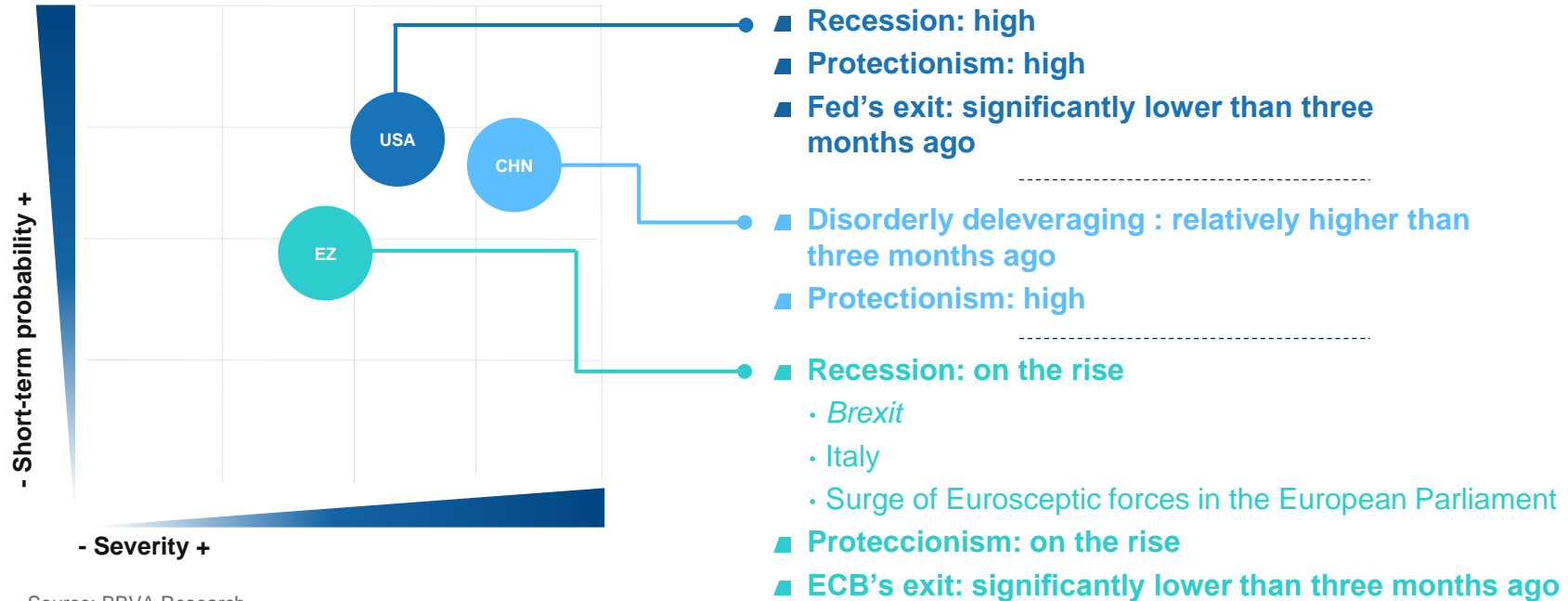
# Eurozone: more prolonged activity weakness to cause lower growth in 2019, some recovery expected in 2020

## Eurozone: GDP growth (% YoY)



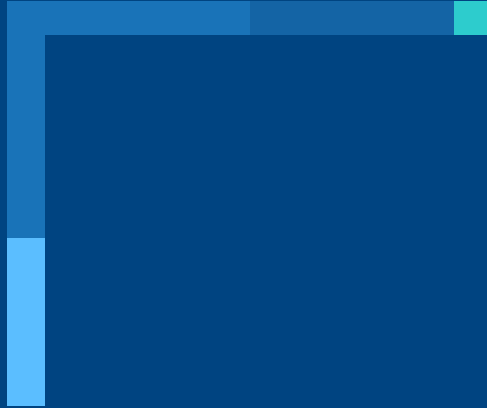
- Downward revision of GDP growth forecasts
- Adjustment in activity expectations concentrated on exports and investment, given lower external demand and lingering uncertainties
- The euro is expected to appreciate from mid-2019 onwards, but at a more gradual pace than expected

# Global risks: increasing fears of trade tensions and economic recession in the US and Eurozone



**Financial vulnerabilities can amplify the severity of the risks**





03

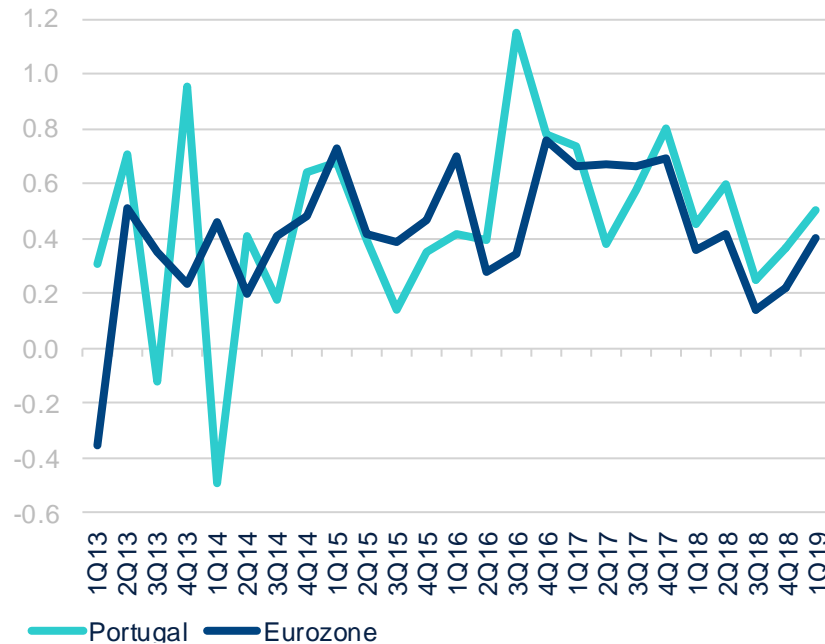
**Portugal Outlook  
2Q19**

# Growth expectations lowered amidst increased risk



# Growth remains relatively solid,...

## Portugal: GDP growth (% QoQ)

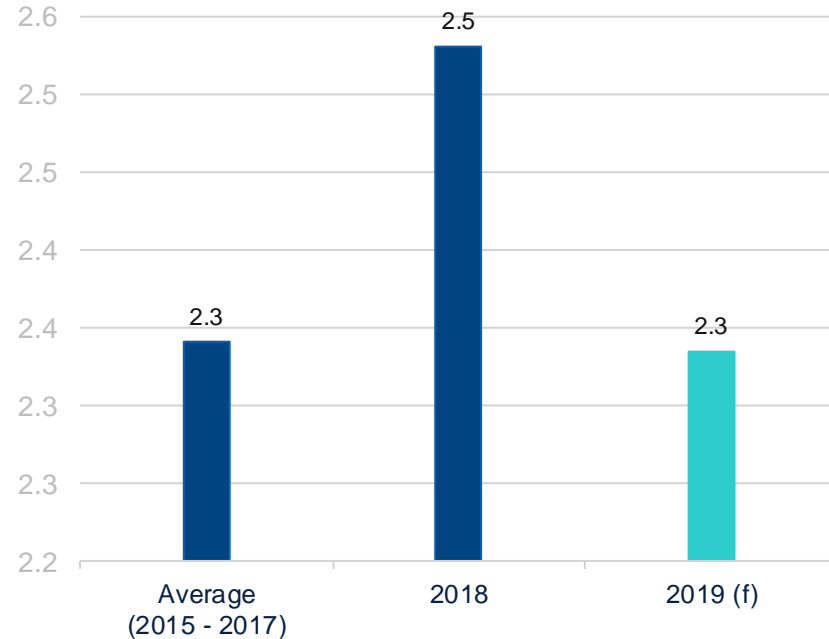


- Portuguese GDP grew 0.5% in 1Q19, exceeding expectations
- GDP growth for 2019 stands at around 1.5% (above the EMU growth forecast of +1.0%)
- The slowdown has come despite a relatively solid performance of domestic demand, and as a result of weaker exports

## ... as domestic demand continues to hold

### Portugal: private consumption

(%)

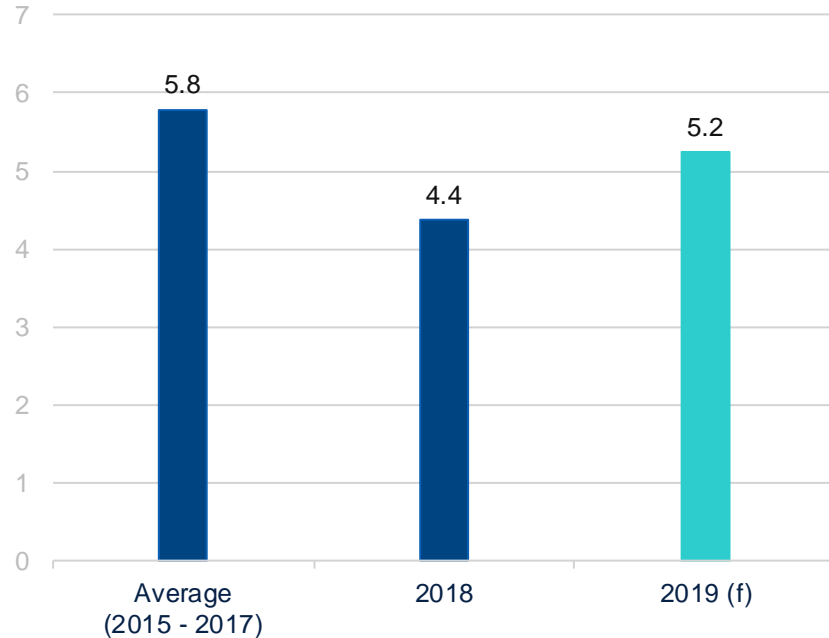


(f) Forecast  
Source: BBVA Research, based on INE data

- **Recent economic policy** (increases in pensions, minimum wage and public sector pay), increased funding and good employment performance are favoring domestic spending
- **An expansionary monetary policy** is maintaining interest payments low, and is pushing credit up

## ... as domestic demand continues to hold

### Portugal: investment (%)

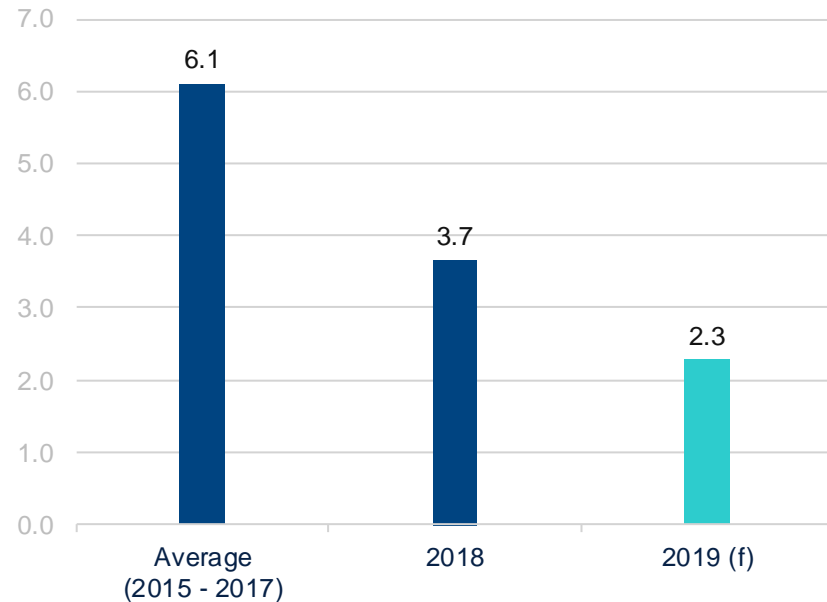


(f) Forecast.  
Source: BBVA Research, based on INE data

- Investment continued to show dynamism during 2018, although at a somewhat lower rate, after the intense growth observed from 2015 to 2017
- Construction accounts for half of all the investment made in Portugal in the last year
- The boom can be seen in the growth in both building permits and the granting of new mortgage loans

# ...but exports have weakened

## Portugal: exports of goods and services in real terms (%)



(f) Forecast.  
Source: BBVA Research, based on INE data

- After the increase seen in 2017, export growth slowed down last year
- If uncertainty surrounding tariff tensions, *Brexit* or recovery in China decline, there will be some improvements in trade
- Gain in competitiveness (depreciation of the euro, fall in oil prices) would further boost export growth

# 2019-2020 Outlook: the economic recovery will continue



## Global demand could recover slightly if uncertainty goes down

Different risk events could be still resolved favorably supporting global recovery



## Expected fall of oil prices during the second half of the year

Production costs should benefit from lower transportation prices, while supporting household spending



## Monetary policy will continue to be expansionary

The Fed and the ECB will continue to support growth by keeping interest rates low for longer. A new round of TLTRO (targeted longer-term refinancing operations) will be launched in Europe and the exchange rate will be further depreciated



## Reduced risk premium

The Portuguese risk premium has been supported by rating decisions, commitment to deficit reduction and reforms, and the pursuit of profitability



## Consolidation of an environment of low uncertainty at domestic level and improved public accounts

result in better financial conditions for firms, households and the public sector

# 2019-2020 Outlook: still far from stagnation

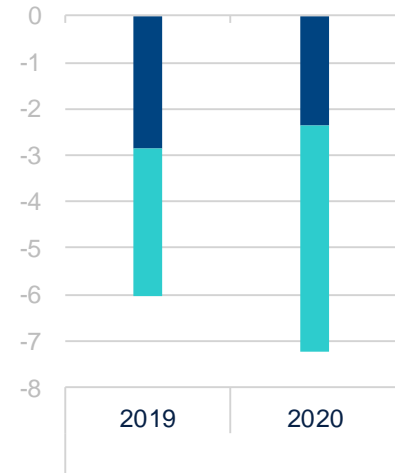
Monetary policy becomes more expansionary

## Changes to financial variable forecasts

(End of period forecast)

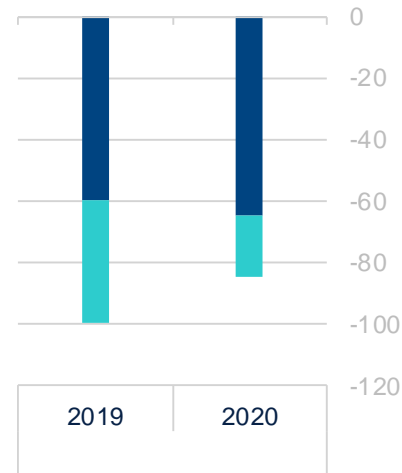
### Exchange rate

(%)



### Long-run German interest rates

(bp)



■ Variation oct18 - jan19 ■ Variation jan19 - apr18

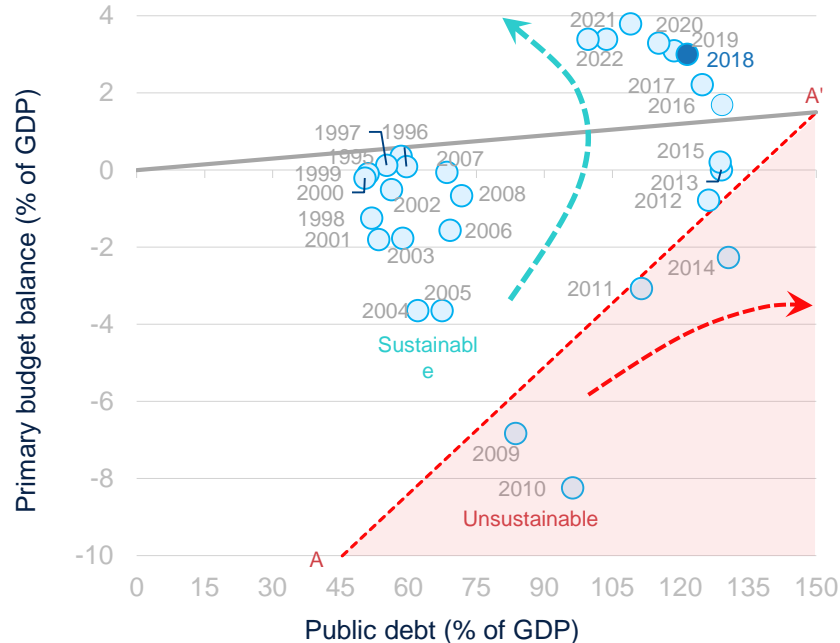
## Financial conditions will continue to be favorable for expenditure decisions:

- The first increase in the official interest rate will not occur until 4Q20
- In addition, the ECB will launch a new round of refinancing operations (TLTROs)
- The euro exchange rate and long-term interest rates are expected to fall below forecasts made three and six months ago



# 2019-2020 Outlook: fiscal consolidation should continue

## Primary budget balance and public debt, 1995-2023

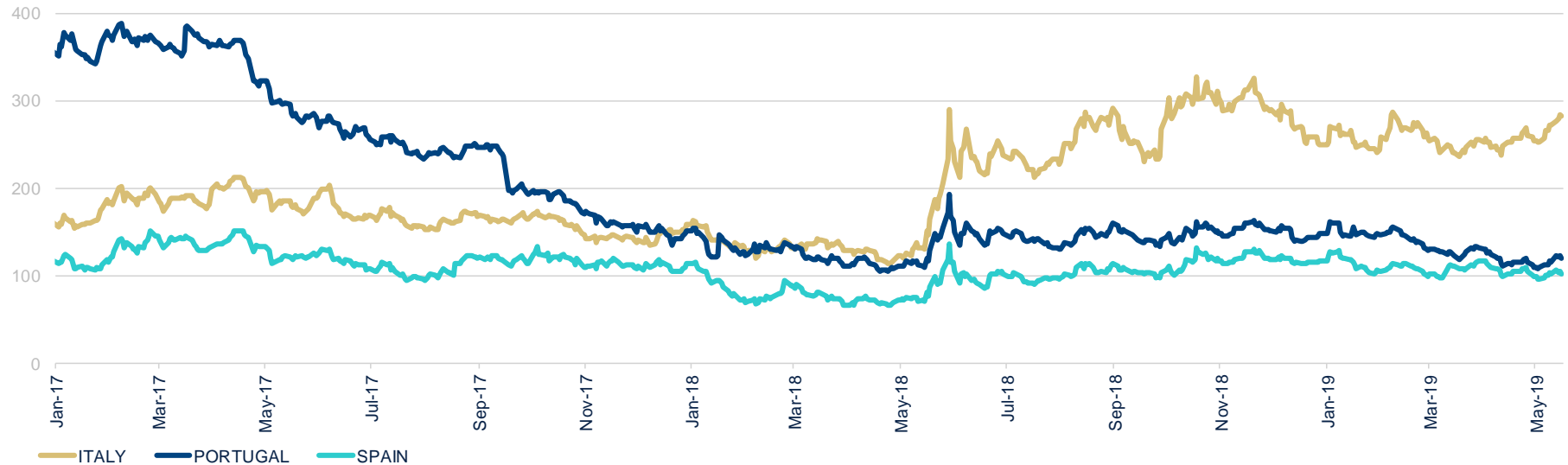


- Fiscal consolidation has contributed to improving the sustainability of public debt, which still remains very high
- This improvement in public finances has contributed to **the reduction of the Portuguese risk premium and better financial conditions**
- The primary budget balance should continue to be above 3% of GDP

# 2019-2020 Better financial conditions

## Risk premiums of peripheral countries

(bp)

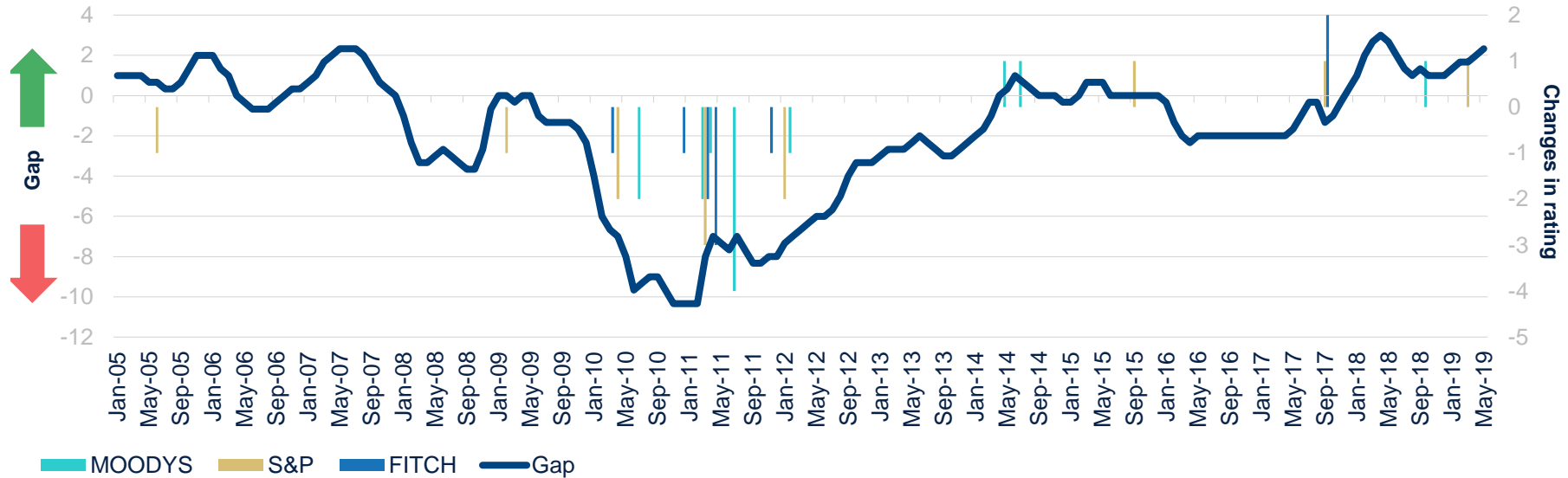


The Portuguese risk premium has been supported by rating decisions and the search for yield

# 2019-2020 Expectations of ratings upgrades

## Pressures on degree of investment

(Difference between CDS-implied rating and agency rating)

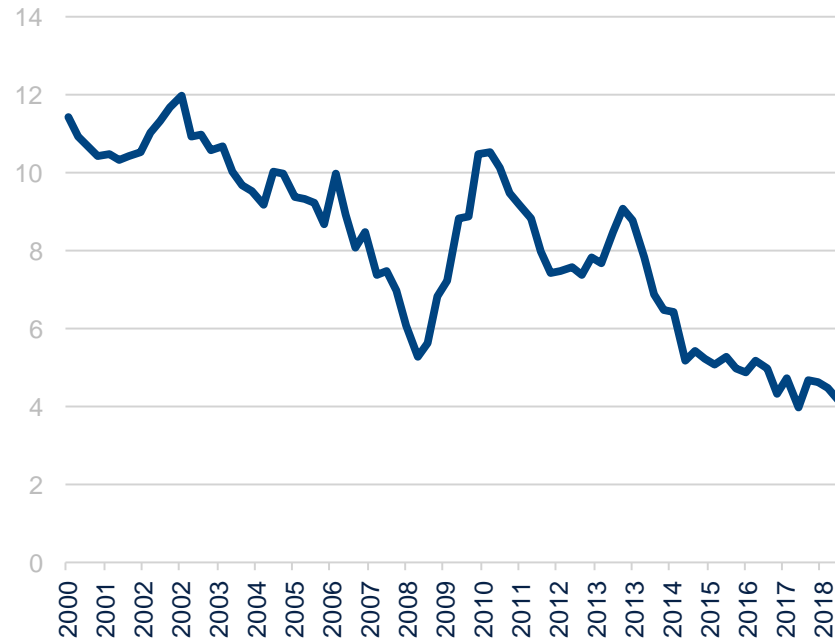


Improved confidence is based on the current upwards pressure on the country's credit rating. In October 2018, Moody's agency upgraded Portugal's sovereign debt rating from junk bond status, following the upgrades made by Fitch and Standard and Poor's

# Risks: the sustainability of consumption growth

## Household savings rate

(%)

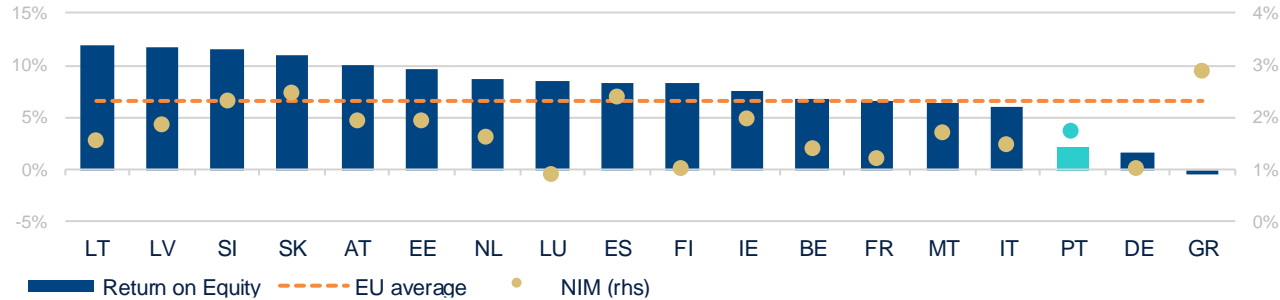


Source: BBVA Research based on Bank of Portugal data

- Positive performance of private consumption is the main driving force in economic recovery
- The decline in savings and growth in consumer financing -supported by expansionary monetary policy- are behind the upturn in household spending
- But the downwards trend in the savings rate is limited ▶ only sustained improvements to income and wealth will lead to lasting growth in consumption

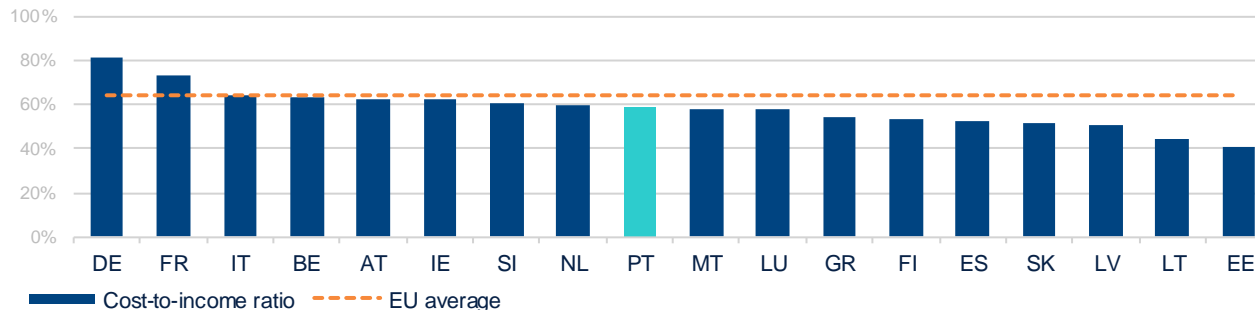
# Risks: modest improvements in profitability, which remains a key challenge for Portuguese banks

## Return on equity



- ROE: 2.2% in Dec-18, far below EU average (6.5%)
- In 2016 and 2017, net income was negative. Net Interest Margin stands at a 1.7%, above the EU average (1.5%)

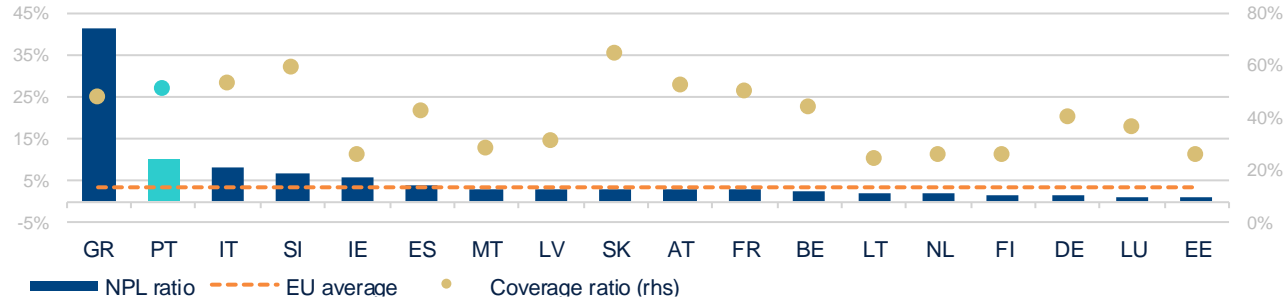
## Cost-to-income ratio



- Cost-to-income ratio: 59.0%, below the EU average (64.6%)
- Pre-provision income slightly higher than EU average: costs harms profitability in the lower part of the P&L

# Risks: despite asset quality has improved, the NPL ratio is still the second highest in the eurozone

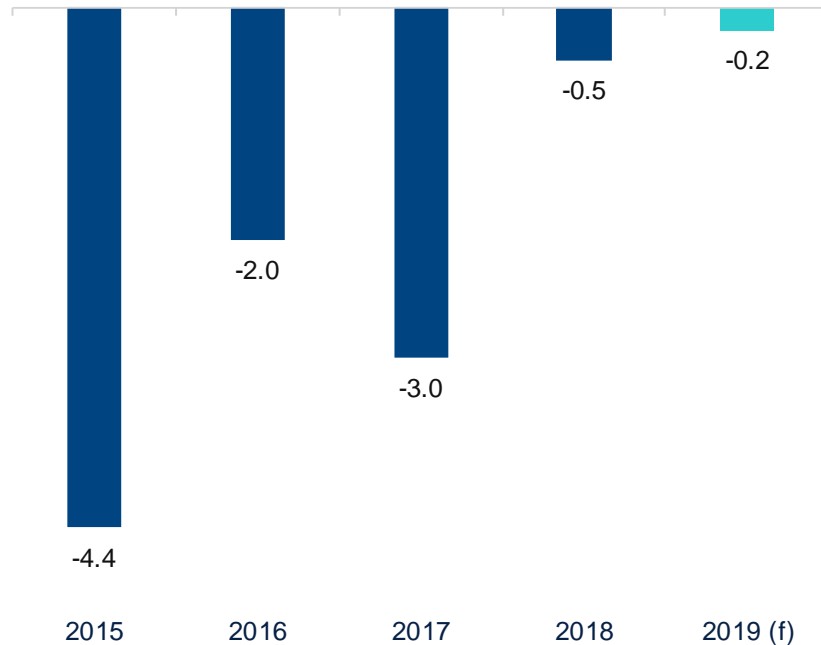
## NPL ratio



- NPL ratio: 10.1% in Dec-18, much higher than the EU average (3.2%).
- Despite the high level of NPLs, coverage ratio is above most of their peers (51.0%).

# Risks: relaxation of fiscal consolidation

## Public deficit (% GDP)

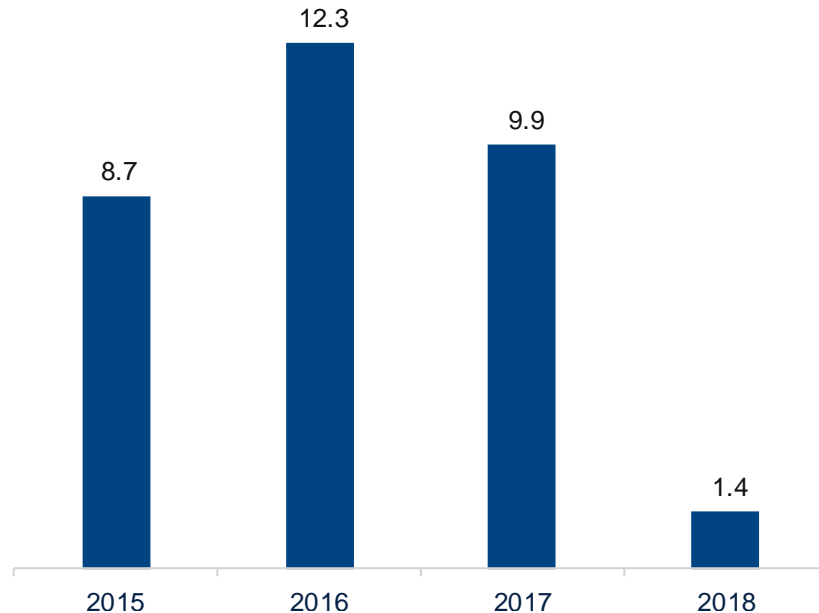


(f) Forecast.  
Source: BBVA Research based on Bank of Portugal data

- The dynamism of public revenues has allowed the public deficit to be reduced (0.5% of GDP in 2018)
- Growth in activity and the government's commitment to fiscal consolidation allow **this year's targets to be met**
- However, **spending control** remains key to maintaining credibility

# Risks: slowdown in the demand of key sectors

## Portugal: overnight stays in hotels (%)



Source: BBVA Research, based on INE data

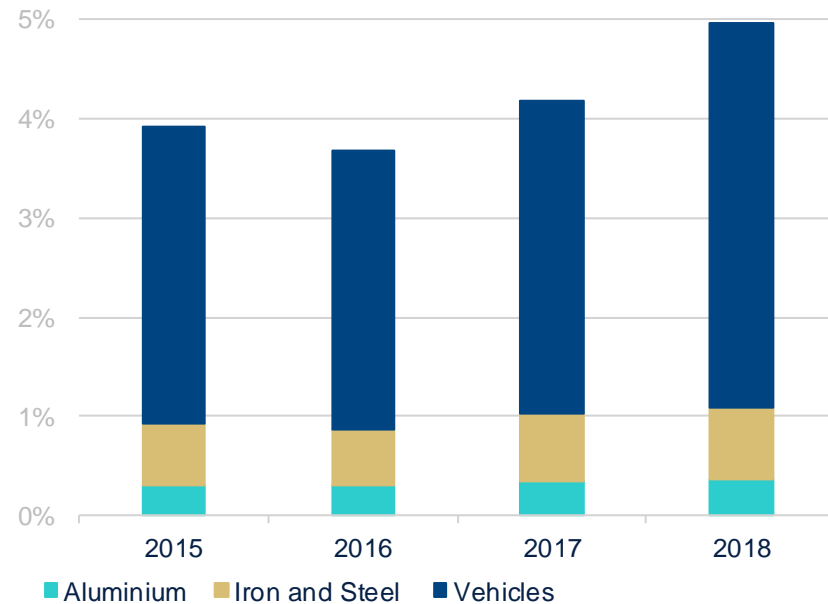
- Following the strong growth seen in previous years, tourism is slowing
- Part of the expansion seen in recent years could be explained by non-traditional factors, such as the deterioration in the perception of security in now-recovering competing destinations
- The trend of tourists turning to other destinations is especially noted in European travellers



# Risks: trade tensions persist

## Product exports that may be affected by the trade war

(% GDP)



\* GDP. Nominal data.

Source: BBVA Research based on Datacomex data

- The threat of higher tariffs on U.S. imports of European cars may have a negative effect on the economy
- Brexit also represents a risk, due to both its direct impact (on exports) and indirect impact (disruption of financial markets)
- On top of this are the uncertainties inherent to the automotive sector (regulation, technological change, etc.)

# 2019-2020: labor market and inflation forecasts

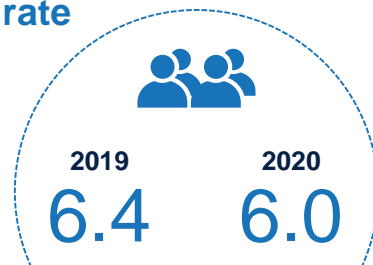
## GDP



## Employment growth



## Unemployment rate



## Inflation



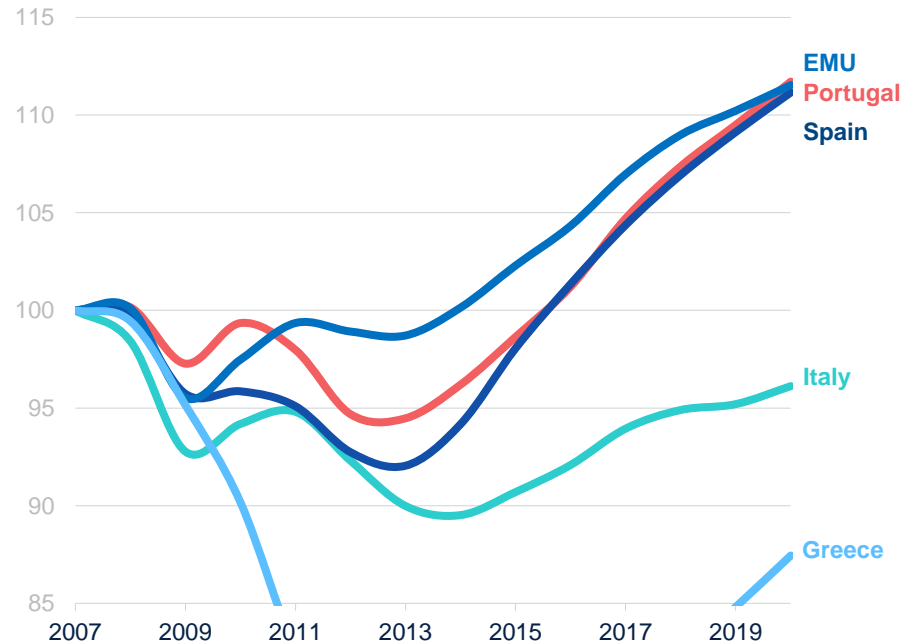


# 04

## The long-term challenges of the digital revolution

# Portugal has surpassed pre-crisis income levels thanks to a favorable combination of external and internal factors

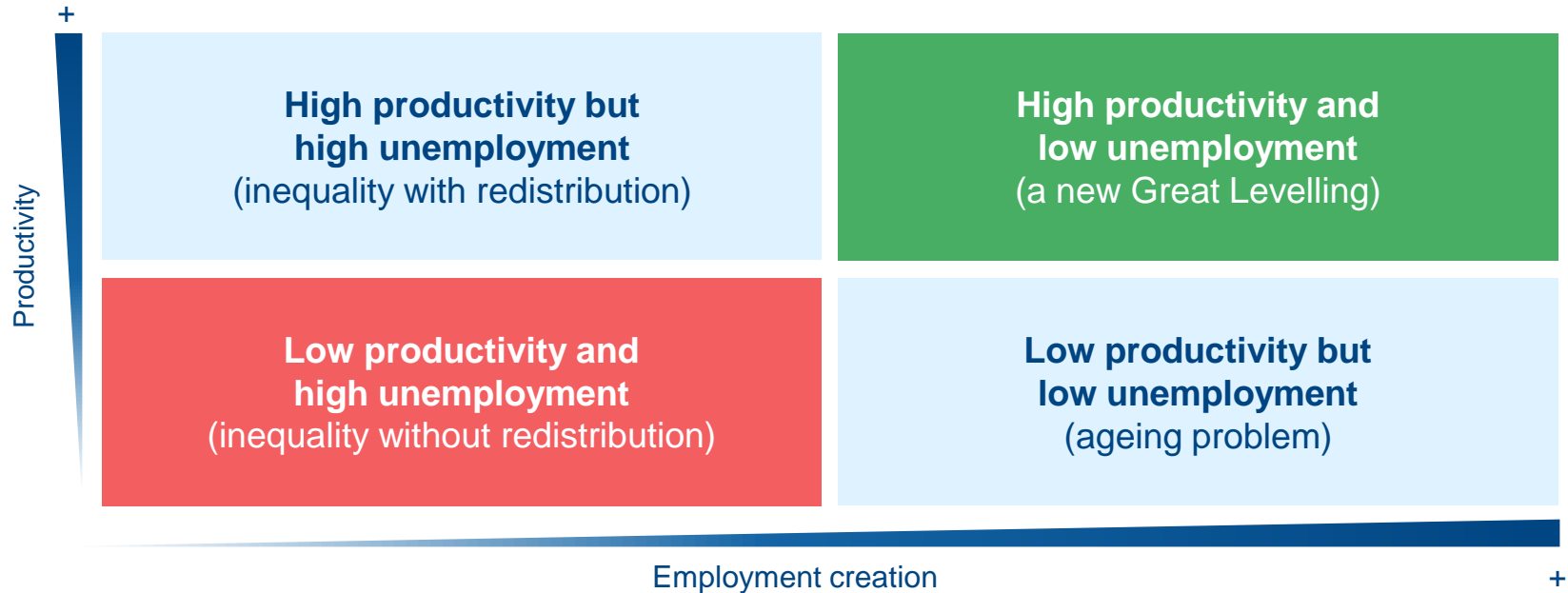
## GDP per working-age population, 2007-2020 (2007=100)



Source: BBVA Research and European Commission

- The recovery has been much more than the natural rebound from a very deep recession and external conditions
- A simple rebound after the crisis could explain differences with EMU but not with other countries, such as Italy and, more significantly, Greece
- Portugal and other countries such as Spain and Ireland have also benefited from structural reforms
- The unemployment rate is now below pre-crisis levels without overheating the economy, but the saving rate and productivity growth are low

# The challenge of the digital revolution: winners or losers?



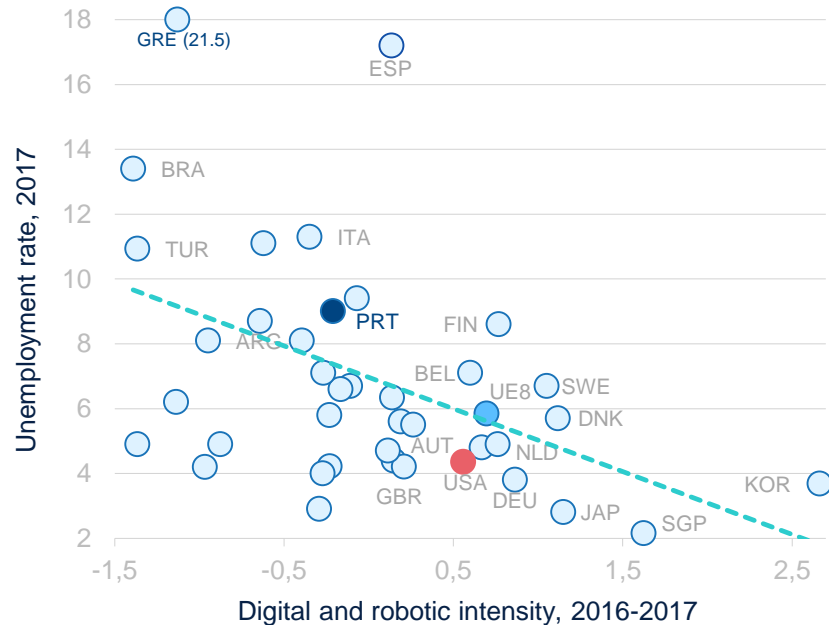
Countries may end up in very different scenarios, depending on how they manage the digital revolution, which is generating a new international division of labor and global wealth.  
**Best policies will achieve better results in terms of employment, productivity and inequality.**

# Reforms to face the digital revolution

1. A more efficient and equitable **labor market** in the digital age
2. Fiscal rules, budget stability and improved efficiency of the **public sector**
3. Sustainability and sufficiency of the **welfare state** in the face of an ageing population
4. More productive and bigger **firms**
5. Better **regulations** & business-friendly environment: attract productive external investment
6. Greater internationalization and **competitiveness**: better presence in global value chains
7. Better **institutions**
8. More **innovation** and technological capital
9. Better **human capital** to take advantage of the digital revolution
10. A more inclusive and sustainable growth with more **equality of opportunities**

# 1. A more efficient and equitable labor market in the digital age

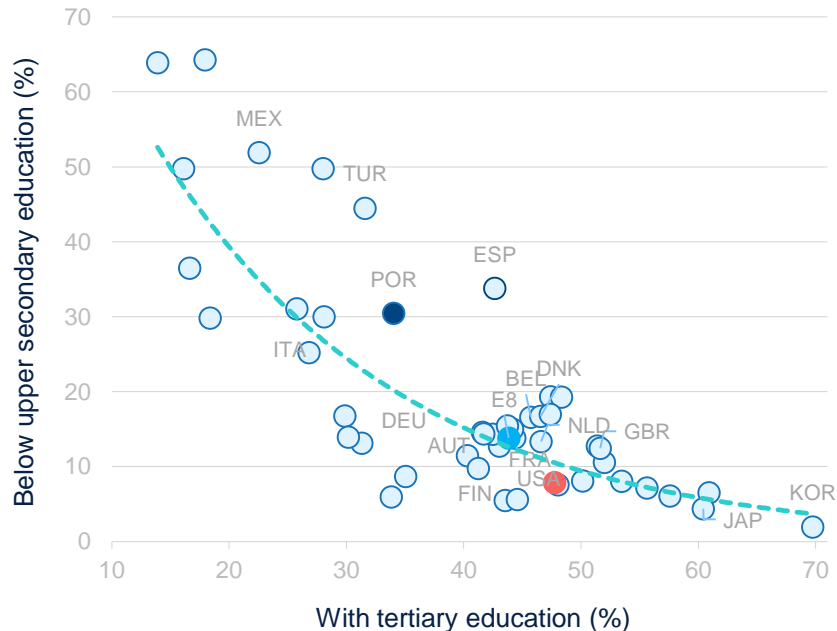
## Digital and robotic intensity, and unemployment in 40 countries, 2016-2017



- There is a negative correlation between the unemployment rate and the digital and robotic intensity
- Although correlation is not causality, so far the evidence across countries is not consistent with the hypothesis that automation implies unemployment at the aggregate level

## 9. Better human capital to take advantage of the digital revolution

Percentage of population aged 25-34 according to their educational level in 2016\*

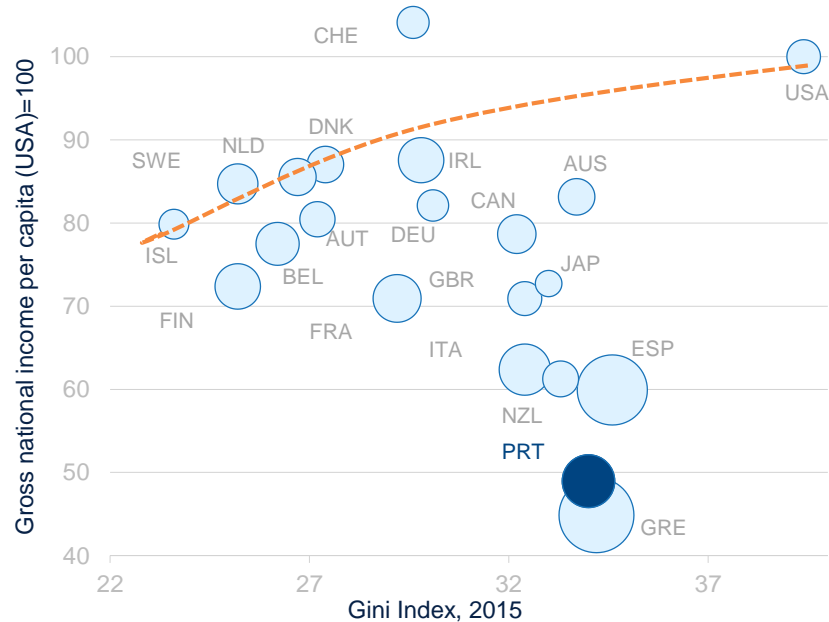


- Skill-biased technical progress and new occupations demand more human capital and more training
- The dual distribution of education in Portugal implies that approximately one third of the young population may not be sufficiently prepared for the digital revolution
- Continue the reduction of early leavers from education and training, and **increase training of the labor force**



# 10. A more inclusive growth with more equality of opportunities

## Per capita income, inequality and unemployment OECD, 2016



Source: BBVA Research based on the OECD and Eurostat. The size of each circle is in proportion to unemployment

- Once that the cyclical recovery is almost complete, it is now necessary to think about the **long-run challenges of the Portuguese economy**
- The challenge is to **manage the technological and digital transformation** by increasing growth while reducing both inequality and the unemployment rate.
- Countries like **Portugal** are far from the frontier, allowing for higher-growth policy strategies that **increase productivity, do not raise unemployment and reduce inequality**

# Reforms to face the digital revolution

- Economic progress and social welfare depend on technical progress in the long run. **Technological and digital transformation represents a unique opportunity, but also enormous challenges**
- The digital revolution is having **disruptive effects** on employment, occupations, required skills, the wage premium, inequality and polarization, but **so far there are no grounds to claim that it affects unemployment at aggregate level**
- It is crucial that the public sector, firms and workers **anticipate and manage actively the digital revolution**, using a wide range of policies that
  - ensure equal opportunities,
  - enhance the long-term positive effects of an inclusive technical and digital progress to bring this age of new opportunities to everyone, and
  - reduce transition costs in the short and medium term

## Key messages

- Global activity remains weak and uncertain, leading to stabilizing economic policies, particularly by central banks, that seek to soften the slowdown in growth. However, trade tensions could derail global growth
- Our GDP growth forecast for Portugal has been revised downwards to 1.5% for 2019, due to lower European demand and increased uncertainty. Recovery will continue thanks to the stabilization of global growth, the support from monetary policy and domestic demand
- There are still numerous risks and, once that the cyclical recovery is almost complete, it is now necessary to think about the long-run challenges of the Portuguese economy, to continue the implementation of policies to reduce its vulnerabilities to changes in the global outlook and to take advantage of the opportunities of the digital revolution. Best policies will achieve better results in terms of higher employment and productivity, lower inequality and more sustainable growth

The logo for BBVA Research, featuring the word "BBVA" in a bold, white, sans-serif font, followed by the word "Research" in a smaller, lighter weight of the same font. A small teal square is positioned to the right of the word "Research".

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# Portugal economic outlook and its long-run challenges

Portugal, from Here to Where? **Lisbon, May 2019**

Creating Opportunities