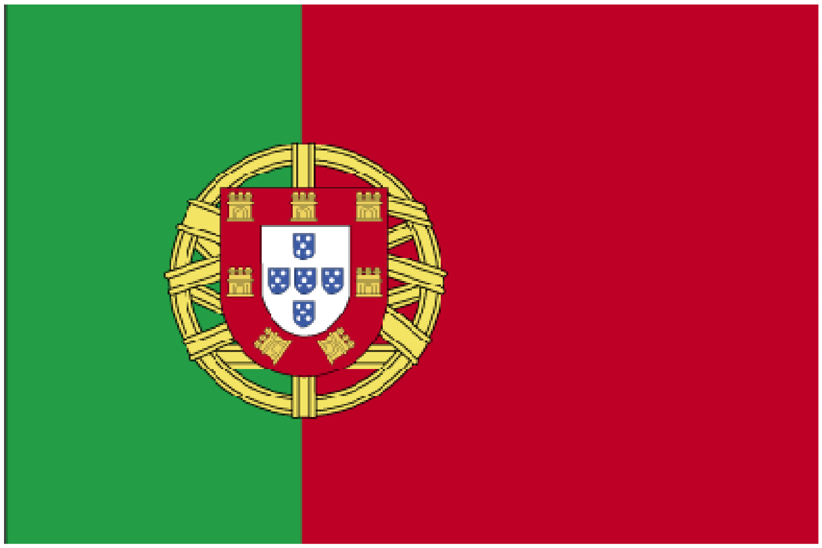
Rabobank

Country report

PORTUGAL



Summary

The Portuguese economy is heading back to recession. After the fall of the government and with serious upward revisions to the public deficit and debt numbers, financial markets lost further confidence, pushing up the interest rate on government bonds to unsustainable levels. We expect the requested European/IMF rescue package will be forthcoming. Strict conditionality coupled with the weaker starting point for the government finances will make for a severe fiscal and economic adjustment going forward.

Things to watch:

- Government deficit reduction
- Banking sector financing and recapitalization needs
- Current account reversal, competitiveness
- Social cohesion, political will and capacity

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Portuguese Republic

National facts	
Type of government	Parliamentary democracy
Capital	Lisbon
Surface area (thousand sq km)	92.09
Population (millions)	10.6
Main languages	Portuguese
Main religions	Roman Catholic (84.5%)
Head of State (president)	Anibal Cavaco Silva
Head of Government (prime-minister)	José Sócrates
Monetary unit	EUR

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	230	0.37
Nominal GDP at PPP	257	0.35
Export value of goods and services	72	0.39
IMF quotum (in mln SDR)	867	0.40
Economic structure	*2010*	*5-year av.*
Real GDP growth	1.5	0.4
Agriculture (% of GDP)	3	3
Industry (% of GDP)	24	25
Services (% of GDP)	74	72
Standards of living	*USD*	*% world av.*
Nominal GDP per head	21607	220
Nominal GDP per head at PPP	24107	206
Real GDP per head	18496	231

Social and governance indicators	rank / total
Human Development Index (rank)	40 / 169
Ease of doing business (rank)	31 / 183
Economic freedom index (rank)	69 / 179
Corruption perceptions index (rank)	32 / 178
Press freedom index (rank)	40 / 178
Gini index (income distribution)	38.5

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
Spain	28	Spain	33
Germany	13	Germany	14
France	12	France	8
Angola	7	Italy	6

Main export products (%)	
Machinery and transport equipment	26
Food, drinks and tobacco	11
Chemicals and related products, n.e.s.	7
Raw materials	5
Main import products (%)	
Machinery and transport equipment	29
Mineral fuels, lubricants, and related materi	12
Food, drinks and tobacco	12
Chemicals and related products, n.e.s.	12
Openness of the economy	
Export value of G&S (% of GDP)	29
Import value of G&S (% of GDP)	36
Inward FDI (% of GDP)	1.2

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economy heading back to recession

Although the impact of the global financial crisis and recession was relatively small, with Portuguese GDP falling only 2.5% in 2009 and recovering by 1.4% in 2010, the economy is expected to fall back into recession in 2011. Government spending is set to fall, due to necessary austerity measures. The conditions attached to the financial assistance that was requested from the European Commission and the IMF will possibly lead to a faster pace of deficit reduction, and will probably push down producer- and consumer confidence. Lower transfers and higher taxes together with falling employment put downward pressure on real disposable incomes. Rigorous changes to social security, taxes, and most likely also labour market institutions can push up the household saving rate. Portuguese firms are faced with scarce and expensive credit and are likely to see the need for deleveraging to strengthen their balance sheets. As such, private consumption and investment are set to decline this year. Export growth will not be strong enough to offset the negative impact of falling domestic demand. The renewed recession will push up the unemployment rate further, after already rising from 7.3% in the second quarter of 2008 to 11.1 late 2010. With the Portuguese economy set for a very difficult adjustment phase, a sharper path of interest rate hikes in light of relatively robust economic growth in other parts of the euro zone is a significant risk for Portugal, notably also because the majority of mortgages has a variable interest rate.

Banks caught between domestic borrowers and foreign lenders

Although public finances are weak, investor sentiment towards Portugal is not just based on relatively high public deficits or debt. The non-financial corporations have been increasing their borrowing very heavily since interest rates came down due to euro-membership. Domestic household savings have by no means been high enough to fund both the public deficits and financing needs of the corporates over the past years. This has resulted in sizeable net-borrowing from other countries, which is visible in the current account deficit. At an average 9.6% of GDP in 1999-2009, Portugal had one of the largest current account deficits in the euro zone, building up into a very sizeable negative net international investment position exceeding 100% of GDP. Banks have a very important role as an intermediary between Portuguese borrowers and foreign lenders. As a result of the shortfall in domestic savings, banks have become very reliant on foreign wholesale funding. Due to the maturity mismatch, the effect of a loss in confidence in the country as a whole means that banks face a funding shortage, leading them to become more dependent on ECB liquidity to replace maturing short term wholesale funding. So even though the banks do not face the loan losses associated with the collapse of a real estate bubble that Spain and Ireland are currently confronted with, its banks are still very vulnerable because of the reliance on foreign wholesale funding. And of course, the new recession will push up non-performing loans this year and next. The potential of bank failures and possible costs to the government of financing the banking sector mean that the fragile financial situation of the country as a whole, which is evident in the funding difficulties of its banks, eventually also leads to heightened risk of the government finances. One or more banks needing government support could quickly push up public debt to levels that will make it harder to get the government finances back on a sustainable path.

Government finances worse than previously thought

Despite mid-2010 spending and revenue measures, the government did not succeed in bringing down its budget deficit in 2011. Even worse, a Eurostat audit of the government accounts concluded that costs related to financial help to the banking sector had not been properly accounted for. What's more, expenditure by government owned transport companies had also not been properly registered, pushing up the deficit by 0.5% every year since 2007. In all, the current estimate for the government budget deficit in 2010 is now 9.1% of GDP, against a stated goal of 7.3%. Coupled with revisions to the deficits of in the previous years, this has pushed up the expected government debt level for this year from 88.8% of GDP to 97.9%. As such, apart from the lack of success in reducing the deficit, the revised figures show a much weaker situation of the Portuguese government finances than what we knew before.

New government to preside over years of tough budget cutting

A Socialist Party (PS) minority government fell on a vote over further austerity measures. This led to further pressure on sovereign interest rates and resulted in the recognition that the government would not be able to obtain market finance at sustainable interest rates, leading to a request for a financial rescue package to the European Commission and the IMF. We do not expect the fall of the government to be an impediment to the implementation of a financial rescue package, either by the current government or by the new government after a bridge loan. We also do not foresee a new Finnish government as being able to block a rescue package. Elections are scheduled for June 5th, and will probably be won by the main opposition Social Democratic Party (PSD). Although they voted against the most recent budget proposal by the PS, this party does acknowledge the need for fiscal austerity. It is unclear if they will be able to obtain an absolute majority. As such, it is still too soon to conclude that the elections will result in a more stable government that can see through the necessary austerity measures and structural reforms. Given the scale of the fiscal adjustment needed and the many areas of necessary structural reform, we cannot take a successful adjustment in Portugal for granted.

Portugal

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	1.4	2.4	0.0	-2.5	1.4	-1.0	-0.4
Consumer prices (average % change pa)	3.1	2.4	2.6	-0.8	1.4	2.5	1.1
Current account balance (% of GDP)	-10.7	-10.2	-12.6	-10.2	-9.2	-6.7	-5.7
Economic growth							
GDP (% real change pa)	1.4	2.4	0.0	-2.5	1.4	-1.0	-0.4
Gross fixed investment (% real change pa)	-1.3	2.6	-1.8	-11.6	-3.8	-0.6	0.4
Private consumption (real % change pa)	1.8	2.5	1.8	-1.0	1.8	-1.1	-0.4
Government consumption (% real change pa)	-0.7	0.5	1.1	3.4	2.0	-2.1	-0.6
Exports of G&S (% real change pa)	11.6	7.6	-0.3	-11.7	9.3	4.9	2.0
Imports of G&S (% real change pa)	7.2	5.5	2.8	-10.6	5.2	3.0	1.3
Economic policy							
Budget balance (% of GDP)	-4.1	-2.8	-3.0	-9.4	-7.3	-7.0	-6.1
Public debt (% of GDP)	64	63	65	76	81	88	93
Money market interest rate (%)	3.0	4.0	3.8	1.0	0.8	1.0	1.9
M2 growth (% change pa)	9	8	15	6	10	3	1
Consumer prices (average % change pa)	3.1	2.4	2.6	-0.8	1.4	2.5	1.1
Exchange rate LCU to USD (average)	0.8	0.7	0.7	0.7	0.8	0.8	0.8
Recorded unemployment (%)	7.7	8.0	7.6	9.5	10.8	11.4	11.9
Balance of payments (mln USD)							
Current account balance	-21534	-23516	-31852	-23952	-21000	-14800	-12000
Trade balance	-23108	-26450	-33787	-24411	-23400	-18900	-16700
Export value of goods	45017	52801	57871	44494	48800	54700	54000
Import value of goods	68124	79252	91658	68904	72170	73600	70690
Services balance	6353	8992	9733	8418	9000	8900	8300
Income balance	-7944	-9632	-11442	-10952	-9500	-7800	-6100
Transfer balance	3165	3574	3644	2993	2900	2900	2600
Net direct investment flows	3794	-2494	1908	1562	1820	1670	1380
Net portfolio investment flows	5224	13681	22841	18108	18300	19000	19700
External position (mln USD)							
Total foreign exchange reserves	2064	1258	1309	2455	n.a.	n.a.	n.a.
International investment position	-166965	-221451	-229901	-264559	n.a.	n.a.	n.a.
Total assets	368764	442737	402346	447271	n.a.	n.a.	n.a.
Total liabilities	535729	664188	632247	711830	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-11.5	-11.5	-13.4	-10.4	-10.2	-8.6	-8.0
Current account balance (% of GDP)	-10.7	-10.2	-12.6	-10.2	-9.2	-6.7	-5.7
Inward FDI (% of GDP)	5.4	1.3	1.9	1.2	1.3	1.4	1.4
International investment position (% of GDP)	-83.0	-95.9	-90.9	-113.0	n.a.	n.a.	n.a.

Source: EIU