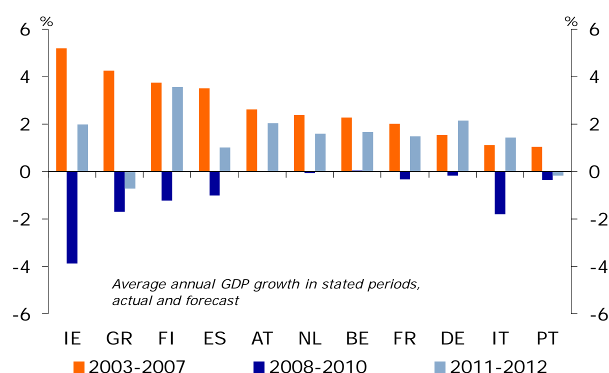
Portugal

Structural weakness

The Portuguese economy was impacted on a relatively limited scale by the global recession and is not being affected by the aftermath of a burst real estate bubble. While government finances are weaker than desired, they are not nearly as bad as in some other European countries. Investors are nonetheless worried. Their concerns are justified considering the pre-existing structural weaknesses and extremely high foreign debt of the country as a whole.

Figure 1: Limited recession, but low growth



Source: NIESR, Rabobank

Back to recession

The GDP volume in Portugal decreased by 0.3% in the fourth quarter of 2010 compared with the previous quarter. We expect that GDP will continue to contract in the first half of 2011, which will drive Portugal back into recession. This is being caused first of all by the steady decline in consumer confidence that began in the autumn of 2009. By the end of 2010 consumer confidence had fallen back to the lowest point reached during the worst phase of the global recession. As a result the decline in consumer spending that occurred in the second half of 2010 is set to continue in the first half of 2011. This downward course is reinforced by high unemployment and limited prospects for a jobs recovery in the short term.

Also, a range of austerity measures was introduced last January aimed at further reducing the budget deficit. The VAT rate was raised, public sector employee wages were lowered and pensions were frozen. Spending cuts directly limit economic growth through lower government spending. There will also be little reason for businesses to make additional investments in light of considerable unutilised production capacity and a poor outlook for domestic demand. Growth in exports will only be able to compensate for this on a limited basis, particularly considering the extremely slow pace at which growth in wages adapts to economic conditions in Portugal. Last but not least, the banking sector is facing funding difficulties, making it hard for businesses that want to invest to obtain loans. This all points to a poor economic outlook for Portugal in the year ahead.

Over the past three years, the Portuguese economy actually held up quite well. It was one of the better performing countries in the eurozone (figure 1) in terms of average growth in 2008-2010. The relatively mild recession nonetheless had a substantial effect on unemployment. The unemployment rate rose from 7.5% in the first quarter of 2008 to 11.1% in the third quarter of 2010. We illustrated in *Rabobank Outlook 2011* that this is attributable to low labour market flexibility.

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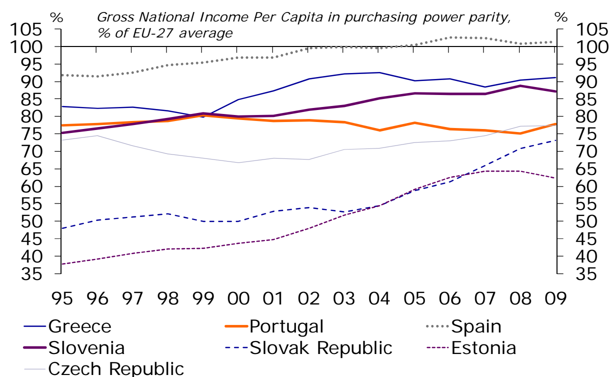
Structurally lagging behind

While Portugal performed relatively well in 2008-2010, the country had a history of lagging behind in Europe during the years preceding the global recession. We expect Portugal to once again slip to the rear of the European peloton (figure 1). As a result of lagging economic growth, national income per capita remains markedly lower than the EU-27 average despite years of European economic integration and participation in the euro (figure 2). Notwithstanding all the European subsidies and considerably lower interest rates due to participation in the euro, Portugal has still not succeeded in climbing economically to the European average level. The case of Slovenia shows how differently things could have turned out. Per capita income in Slovenia was more or less the same as in Portugal in 1995. But in 2009 Slovenia had gained a major lead over Portugal. Slovakia and Estonia, which is the newest eurozone member, have also shown impressive convergence since 1995.

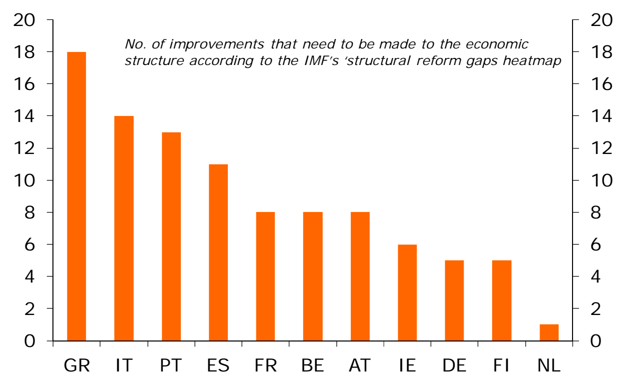
The fact that Portugal is structurally lagging behind is due to a lack of structural reforms. There are numerous regulations and extensive legislation that limit the economy's performance, while too little has been invested in infrastructure, education and innovation. Employee protection regulations have furthermore led to limited labour market flexibility. This has resulted in high growth in wages in relation to the growth in labour productivity and makes adapting the economy from contracting to growing sectors difficult. The chart in figure 3 shows the number of improvements that need to be made to the economic structure in eleven countries according to the IMF. These points for improvement involve labour market flexibility, legislation and regulations for business start-ups, the educational level of the working population and the quality of the infrastructure and innovation. The chart reveals that there is considerable room for improvement in Portugal.

Figure 2: Portugal fails to catch up



Source: Reuters EcoWin

Figure 3: Structural weakness



Source: IMF, Rabobank

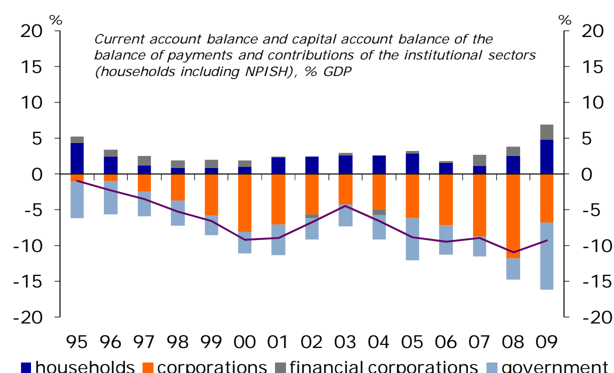
Portugal

More borrowing, but not for investment

In addition to the economy's structural weakness, investment in fixed assets has barely increased since 2000. Expanding the stock of buildings and machinery could have contributed to higher economic growth. The fact that this failed to occur despite sharply reduced interest rates thanks to participation in the euro can be considered a missed opportunity. This is not, however, to say that low interest rates were not used to take on more debt. Portugal as a whole has, in fact, borrowed more and more from abroad (figure 4). The government has been spending more than it receives in taxes for years. The sharp deterioration of the balance on the current and capital account of the balance of payments has, however, been caused by the increasingly greater demand of businesses for external financing . While this could be attributed to rising business investments in the second half of the 1990s, businesses have since 2003 taken on more debt without there being a proportionally large increase in investments.

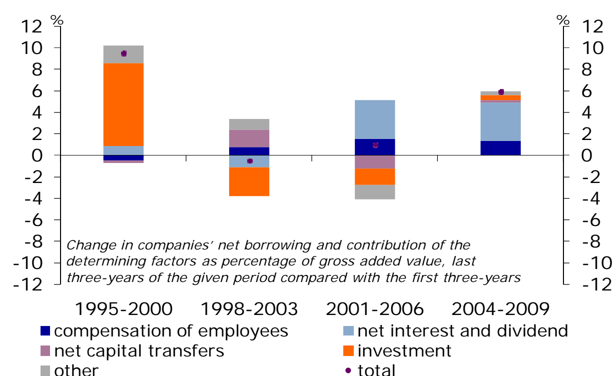
A further examination of the income and expenditure of Portuguese businesses points to three causes (figure 5). First, the gross operating result fell from more than 38% of added value in 2002 to 35% in 2008 due to a sharp rise in wages. Secondly, an increasingly greater proportion of added value minus wage and interest payments has been paid out in dividend. Dividend payouts rose from less than 30% in 2002 to more than 70% in 2008. This reveals that businesses chose to finance an increasingly smaller portion of investments with retained earnings. Thirdly, interest payments on previous debt rose sharply from 2005. Due to the increased use of external financing, Portuguese businesses have become very sensitive to changes in interest rates. This is clearly demonstrated by the increased interest expenses since 2005. More generally speaking, it must be remembered that interest and instalments still have to be paid even in the event of disappointing returns on investment.

Figure 4: Deficits at corporations and government



Source: Reuters EcoWin

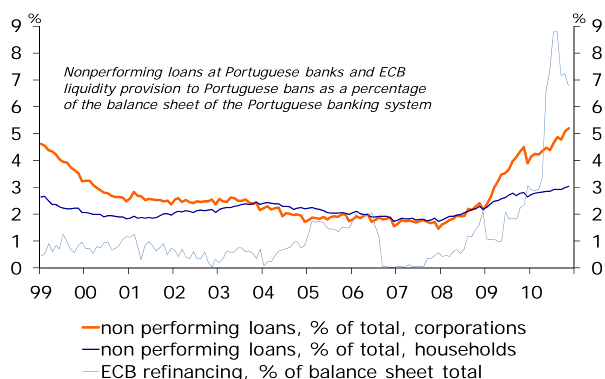
Figure 5: Borrow for wages, interest and dividend



Source: Reuters EcoWin, Rabobank

In that case either dividend payouts or wages can be lowered. However, that does not solve the problem, but rather only shifts it to the households that would see their disposable income decrease.

Figure 6: Problems in the banking sector



Source: Reuters EcoWin, ECB, Rabobank

Banking sector is the weakest link

The Portuguese banking sector forms an important link between foreign investors and Portuguese households and firms. As a result it is the first to run the risks connected with the unfortunate macroeconomic debt position. The 2009 recession led to an increase in the number of non-performing loans. And during the Greek and Irish debt crises, investors also expressly abandoned Portuguese banks, forcing the banks to obtain an increasingly greater part of their financing from the European Central Bank (figure 6). The new recession will spur a further increase in the number of defaults. This situation will also lead to a heightened risk for government finances. Investors anticipate that the government will bail out large banks should they run into trouble, as previously was the case in Ireland and Spain. This can trigger a further and rapid rise in government debt. The risks of the national debt position will therefore ultimately fall largely on the shoulders of the government.

It will take time to adjust

While the deficit on the current account of the balance of payments will decrease further this year, Portugal will continue to live far beyond its means. This will lead to a further accumulation of national debt. In addition, little is being done to strengthen the economic structure. As long as the sizeable debt position continues to exist and the country does not succeed in improving the economic structure, the accompanying risks will also remain. It will be difficult for the Portuguese government to find a solution in the short term to the debt position that has been built up over many years. As a result it will also be hard to convince investors of the soundness of government finances. It is therefore probable that the country will ultimately need financial aid from its European partners. This will accelerate the adjustment process and the structural reforms in the same way that this is already happening in Greece. While this will lead to a deeper recession in the short term, it would be the best solution for Portugal in the longer term. Without painful measures the adjustment process will take place slowly and the country will remain highly dependent upon external financing. In that case the risk of a financial crisis will continue to exist.

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