Rabobank

Country report **PORTUGAL**

Summary

Portuguese economic activity fell sharply over the past year and unemployment rose. We expect the economy to contract further this year as government austerity pushes down domestic demand and export growth will not be strong enough to compensate for this. The government successfully reduced the budget deficit last year, albeit with the help from some one-off revenue measures. In March, the IMF concluded that the government was on track with meeting the conditions attached to the financial assistance package. This concerns the budgetary execution as well as privatization, structural reform in the labor market, restructuring state owned enterprises and deleveraging /recapitalization of the banking sector. Even so, government bond yields remain high and Portugal will probably need a second financial support package from the EC/IMF.

Things to watch:

- Government deficit reduction, social cohesion, political will and capacity
- Banking sector financing and recapitalization needs
- Government bond yields, negotiations about a second rescue package

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Portugal

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)	Pedro Passos Coelho
Monetary unit	EUR

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	238	0.34
Nominal GDP at PPP	274	0.35
Export value of goods and services	85	0.39
IMF quotum (in mln SDR)	1030	0.47
Economic structure	*2011*	*5-year av.*
Real GDP growth	-1.6	0.5
Agriculture (% of GDP)	3	3
Industry (% of GDP)	23	24
Services (% of GDP)	75	74
Standards of living	*USD*	*% world av.*
Nominal GDP per head	22333	207
Nominal GDP per head at PPP	25690	208
Real GDP per head	18066	222

Social and governance indicators	rank / total
Human Development Index (rank)	41 / 187
Ease of Doing Business Index (rank)	30 / 183
Index of Economic Freedom (rank)	68 / 179
Corruption Perceptions Index (rank)	32 / 183
Press Freedom Index (rank)	33 / 178
Gini index (income distribution)	38.5
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Spain	26	Spain	31
Germany	13	Germany	14
France	12	France	7
Angola	5	Italy	6

Main export products (%)	
Machinery and transport equipment	27
Food, drinks and tobacco	10
Chemicals and related products, n.e.s.	8
Raw materials	7
Main import products (%)	
Machinery and transport equipment	30
Mineral fuels, lubricants, and related materi	14
Food, drinks and tobacco	12
Chemicals and related products, n.e.s.	12
Openness of the economy 2011	
Export value of G&S (% of GDP)	31
Import value of G&S (% of GDP)	38
Inward FDI (% of GDP)	0.6

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

Severe economic contraction

Real GDP fell in the five quarters to the end of 2011 at an average rate of 0.6% per quarter and was down 1.6% on average in 2011 compared to 2010. In the last quarter of 2011 the level of GDP reached a new low point relative to the pre-recession peak of the first quarter of 2008. Economic activity was 5.1% below that peak versus a previous low in the first quarter of 2009 at 4.1%. Actually, the recovery that started in the second quarter of 2009 had already reduced the peak-trough difference to 2% by the third quarter of 2010. So, even though the Portuguese recession was relatively mild by European standards at first and the recovery was rather solid, the austerity-induced renewed recession has now pushed economic damage in Portugal firmly towards the lower end of the European spectrum. Both consumer and producer confidence sharply declined in reaction to trouble in Greece and Ireland and later due to its own need for financial assistance and the ensuing austerity drive. All components of domestic demand contracted sharply in 2011. This was only partly compensated by lower imports. Robust export growth was able to significantly further cushion the blow to domestic production. We expect domestic demand to keep contracting this year as government spending is further reduced. Households will see their real disposable income fall due to lower transfers and higher taxes while employment continues to fall. Uncertainty and the need to deleverage means that they will keep their saving rate high. As such, another sharp fall in private consumption is likely. Private investment by domestically oriented firms will fall as a result. Export growth will probably be less supportive this year as most eurozone economies go through recession and world trade growth is unlikely to significantly pick up before the second half of the year. GDP is widely expected to fall by more than 3% this year. A positive development

is the stabilization and modest rise in the Economic Sentiment Indicator including the consumer confidence sub index since December 2011. The level of the index is still consistent with sizeable quarterly falls in GDP, but the fact that it has stopped declining suggests that the recession is at least not intensifying. This also seems to be mirrored in the somewhat smaller increases in the unemployment rate in January and February of this year, coming down slightly from a record setting rise in unemployment in the second half of last year. The unemployment rate shot up from 12.5% of the labor force in July 2011 to 14.6% in December and reached 15% in February 2012. This compares to a pre-recession level of close to 8%.

Government doing what is needed

In this economic environment, the center right coalition government that was formed by the Social Democrats and the Peoples Party after the June 2011 elections will have a hard job to further reign in the budget deficit. Still, since the coalition has a 17 seat majority in the 230 seat parliament and does not face elections for a number of years, this makes for a much more stable political situation than with the previous Socialist minority government. When coming to power in the middle of 2011, the new government immediately corrected fiscal slippage from the first half of the year. But with only half of the year in office they had to resort to one-off revenue measures to meet the deficit target agreed with the EC/IMF in the context of the financial rescue package. In the end, they overcompensated, bringing the budget deficit down from 9.8% of GDP in 2010 to 4% in 2011 against an agreed 5.9% target. The one-off measures have been replaced by structural expenditure and revenue measures in the 2012 budget, with the aim to achieve a 4.5% deficit this year. In March, the IMF concluded that the government was on track with meeting the criteria. This concerns the budgetary execution as well as privatization, structural reform in the labor market, restructuring state owned enterprises and deleveraging/ recapitalization of the banking sector. An important problem for Portugal is the very large net international debtor position worth 110% of GDP. This is the result of years of sizeable current account deficits and has made the banking sector very reliant on foreign wholesale funding. The ongoing recession will push up non-performing loan ratio's, undermining already weak investor confidence. As a result, there is a clear risk that current private debts will partially be migrating to the government balance sheet when banks have to be supported further.

Greece an unlikely blueprint for Portugal

Although government bond yields have fallen somewhat from earlier crisis peaks, with the 2-year yield above 12% and 10-year yield at over 10% it is currently not possible for the government to return to market financing. The rescue package fully covers the governments' financing needs up to and including the first half of 2013. Even so, it is unlikely that the government will succeed in lowering bond yields by regaining market confidence soon enough. Discussions about a second rescue package for Portugal will likely start in the second half of this year, since the IMF can only distribute loan tranches from the current package if there is sufficient financing for the country on a 12-month horizon. Given the good performance so far, it is likely that Portugal will remain largely on track in meeting EC/IMF conditionality. If that is the case, we expect a second loan package to be forthcoming without the restructuring of privately held government bonds that we have seen in Greece. This is underpinned by our idea that an IMF sustainability analysis, that will ask the question if a reasonable macro-economic adjustment package can stabilize and lower the debt ratio, would probably lead to a positive verdict. Portugal was already relatively well prepared for the ageing of the population due to pre-crisis reforms to the pension system. Further reform to pensions and health care will have made this longer term sustainability even better. As such, the main challenges are to push the budget balance to a sufficiently high primary surplus that would

gradually lower the debt ratio and to raise economic growth, which was far below the European average in the years leading up to the crisis, in the medium term.

In case of sharp deviations from the agreements with the EC/IMF, additional financing without private sector restructuring is less likely although not completely out of the question. We note that the IMF mission chief has already indicated a number of times that the conditionality will have to be flexible about the precise deficit targets if macro-economic developments turn out worse than expected. More important will be the budgetary efforts and the implementation of reform, which up to now have been strong. The main risk for Portuguese creditworthiness then is a scenario where the budgetary effort is severely undermined by adverse economic developments above and beyond what is currently already anticipated or a loss of political will in pushing through further budget cuts in light of rising popular opposition. If this leads to a sharp deterioration in debt dynamics and the medium term outlook or to strained relations with the EC/IMF, further help will perhaps have to include restructuring of privately held government debt to make new loans available.

Portugal

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	2.4	0.0	-2.9	1.4	-1.6	-3.9	-2.1
Consumer prices (average % change pa)	2.4	2.6	-0.8	1.4	3.7	2.6	1.4
Current account balance (% of GDP)	-10.1	-12.6	-10.9	-10.0	-6.4	-3.1	-1.6
Economic growth							
GDP (% real change pa)	2.4	0.0	-2.9	1.4	-1.6	-3.9	-2.1
Gross fixed investment (% real change pa)	2.6	-0.3	-8.6	-4.1	-11.4	-12.4	-3.0
Private consumption (real % change pa)	2.5	1.3	-2.3	2.1	-3.9	-4.6	-2.6
Government consumption (% real change pa)	0.5	0.3	4.7	0.9	-3.9	-4.3	-3.4
Exports of G&S (% real change pa)	7.5	-0.1	-10.9	8.8	7.4	0.0	2.0
Imports of G&S (% real change pa)	5.5	2.3	-10.0	5.4	-5.5	-6.6	-0.8
Economic policy							
Budget balance (% of GDP)	-3.2	-3.7	-10.2	-9.8	-4.0	-6.0	-4.8
Public debt (% of GDP)	68	72	83	93	113	124	94
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	1.0	0.8
M2 growth (% change pa)	8	15	6	10	5	1	-1
Consumer prices (average % change pa)	2.4	2.6	-0.8	1.4	3.7	2.6	1.4
Exchange rate LCU to USD (average)	0.7	0.7	0.7	0.8	0.7	0.8	0.8
Recorded unemployment (%)	8.0	7.6	9.5	10.8	12.7	14.5	15.3
Balance of payments (mln USD)							
Current account balance	-23516	-31852	-25597	-22850	-15200	-6500	-3300
Trade balance	-26450	-33787	-24831	-24111	-18300	-10900	-9100
Export value of goods	52801	57871	44669	48905	59200	57500	58300
Import value of goods	79252	91658	69501	73017	77500	68420	67410
Services balance	8992	9733	8423	8825	10700	10500	10500
Income balance	-9632	-11442	-12179	-10423	-11600	-9300	-7900
Transfer balance	3574	3644	2992	2858	4100	3200	3200
Net direct investment flows	-2494	1908	1935	9640	757	-100	170
External position (mln USD)							
International investment position	-221550	-230021	-269670	-250064	n.a.	n.a.	n.a.
Total assets	443828	403451	452130	437429	n.a.	n.a.	n.a.
Total liabilities	665378	633472	721800	687493	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-11.4	-13.4	-10.6	-10.5	-7.7	-5.2	-4.5
Current account balance (% of GDP)	-10.1	-12.6	-10.9	-10.0	-6.4	-3.1	-1.6
Inward FDI (% of GDP)	1.3	1.9	1.2	0.6	-0.2	0.2	0.3
International investment position (% of GDP)	-95.4	-91.0	-114.9	-109.1	n.a.	n.a.	n.a.

Source: EIU

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