Country update **PORTUGAL**

Summary
Although Portugal has been very successful in abiding by the conditions of the IMF/EC/ECB troika and therefore has received official financial assistance without delay, the economic and financial situation remains very precarious and uncertain. As a result, there is still a high probability that a second rescue package will be needed. If the country starts to deviate severely from austerity or reform targets, debt restructuring could be part of such a package. But although agreeing on new austerity measures will become increasingly harder for the governing coalition, we continue to regard this is a low probability outcome.

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Portugal

National facts	
Type of government	Parliamentary democracy
Capital	Lisbon
Surface area (thousand sq km)	92.09
Population (millions)	10.8
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

Social and governance indicators	rank / total
Human Development Index (rank)	41 / 187
Ease of Doing Business Index (rank)	30 / 185
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.

Economy	2011	
Economic size	*bn USD*	*% world total*
Nominal GDP	238	0.34
Nominal GDP at PPP	274	0.34
Export value of goods and services	86	0.39
IMF quotum (in mln SDR)	1030	0.47
Economic structure	*2011*	*5-year av.*
Real GDP growth	-1.7	0.5
Agriculture (% of GDP)	3	3
Industry (% of GDP)	23	24
Services (% of GDP)	74	74
Standards of living	*USD*	*% world av.*
Nominal GDP per head	22354	206
Nominal GDP per head at PPP	25705	206
Real GDP per head	18139	222

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Spain	25	Spain	32
Germany	14	Germany	12
France	12	France	7
Angola	5	Italy	5

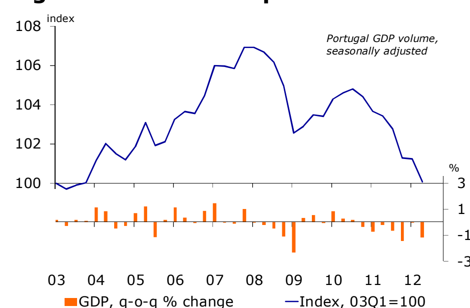
Main export products (%)	
Machinery and transport equipment	27
Food, drinks and tobacco	10
Chemicals and related products, n.e.s.	9
Mineral fuels, lubricants, and related materi	7
Main import products (%)	
Machinery and transport equipment	25
Mineral fuels, lubricants, and related materi	17
Chemicals and related products, n.e.s.	13
Food, drinks and tobacco	13
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)	1.2

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

Recession set to continue

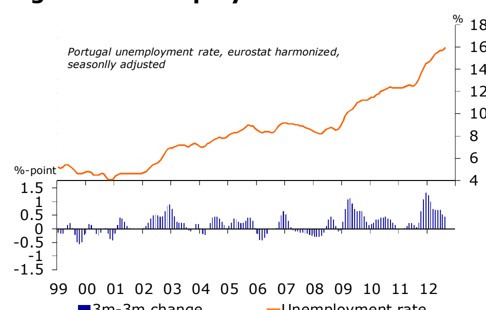
The Portuguese economy has been back in recession since the last quarter of 2010. Up to and including the second quarter of 2012, real GDP has contracted by an average 0.7% per quarter. This fall in economic activity follows after only a partial recovery from the 2008/09 recession and has pushed GDP to 6.4% below its 2008Q1 level (figure 1). Unemployment, having already risen from 8.5% in late 2008 to 12.3% in August 2010, has jumped up sharply over the past year, to almost 16% in August 2012 (figure 2). Despite the ongoing recession and rising unemployment,

Figure 1: GDP development



Source: Reuters EcoWin

Figure 2: Unemployment

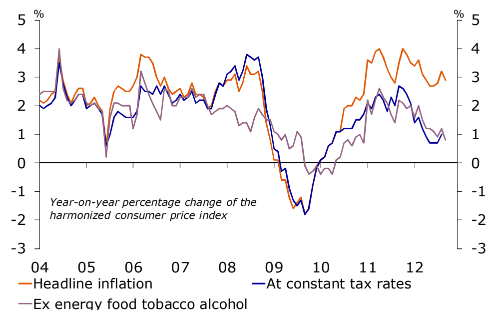


Source: Reuters EcoWin

inflation has remained very high. This is due to increases in indirect tax rates that have been implemented by the government in its efforts to reduce the budget deficit. Both core inflation and

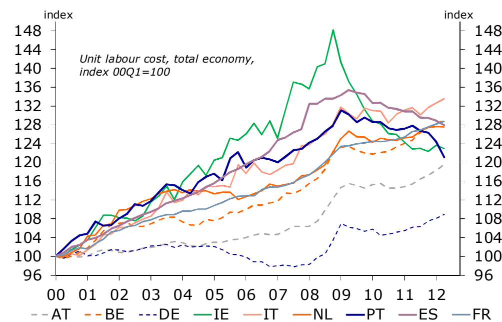
inflation at constant tax rates have come down significantly over the past year and hover around 1% (figure 3). Since a repeat of such sizeable indirect tax hikes is not expected going forward, inflation will fall significantly next year.

Figure 3: Inflation



Source: Reuters EcoWin

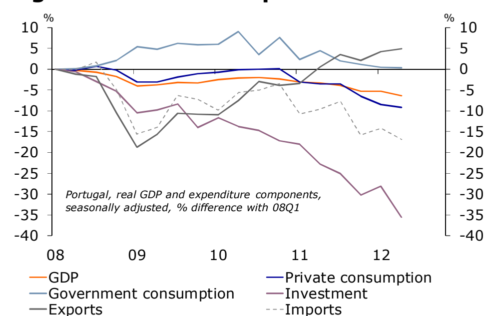
Figure 4: Unit labour cost



Source: Reuters EcoWin

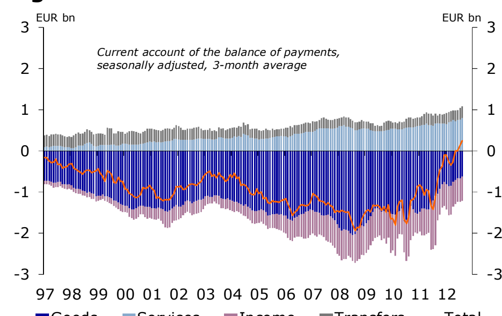
The limited underlying price pressure is helped by modest wage growth for the economy as a whole. Nominal public sector wages have been drastically lowered and compensation has been reduced in some business sectors as well. Combined with productivity increases due to labour shedding, this has resulted in falling unit labour costs (figure 4). Further regaining competitiveness by lowering unit labour costs is essential to ensure that exports will remain an important driver of economic growth. Export growth has staged an impressive rebound from the 2008/09 recession, which together with falling import volumes has limited the impact on GDP of the sharp fall in all categories of domestic demand (figure 5). The combination of higher exports and lower imports has also resulted in a dramatic reduction of the external current account deficit (figure 6). The current account even turned positive in the three months to August 2012.

Figure 5: GDP and expenditure



Source: Reuters EcoWin

Figure 6: Current account balance



Source: Reuters EcoWin

We expect the recession to continue until at least the middle of next year and for any recovery to be very modest because government austerity and private sector deleveraging are likely to continue for years to come. Domestic demand will keep falling due to lower government spending. Austerity measures will also undermine household disposable income, which puts downward pressure on private consumption. Firms catering to domestic demand will see demand for their goods and services decline and cut back on investment spending. Positively, exports will be further supported by the decline in unit labour cost that has been set in motion. In the longer run, the impressive set of structural economic reforms that have been enacted and further planned reforms are likely to lead to higher competitiveness and economic growth. Significant reform of the labour market,

product markets and the judiciary system has already been implemented. But with slow global economic growth and given the relatively low share of exports in GDP, export growth will not be able to sufficiently compensate for the fall in domestic demand for some time to come.

Further austerity and reform becoming harder to achieve

Public expenditure reduction has been successful to date and real GDP is developing in line with the expectations of the macro-economic adjustment program. But the rebalancing of the economy from domestic demand toward external demand has been much more rapid than the IMF/EC/ECB troika had anticipated. Since domestic demand is subject to more taxation than exports and because rebalancing is assisted by lower wage growth and employment, government income has been lower than expected. To prevent the government from having to push up the pace of austerity to meet the agreed nominal budget targets and further undermine economic activity in the process, the troika has granted the country an additional year to lower the deficit to below 3% of GDP. A lower fiscal adjustment in 2012 is compensated for by a bigger than previously planned adjustment in 2013 and 2014. As a result, instead of being completed in 2013, the budgetary adjustment now remains very sizeable in 2014 as well.

Since most relatively easy measures have already been taken, it will become increasingly difficult for the governing coalition partners to agree on new austerity measures. A planned spending reduction by lowering wages in the civil service was blocked by the constitutional court earlier in the year. The hike in the social security contribution of employees that was meant to compensate for this has been abandoned after very large popular protests and tensions in the coalition. The tax hikes that have been announced to compensate for that will lead to a general strike on November 14. As such, the period of remarkable stability of the government, with even the main opposition party supporting the government, and the absence of large scale protests has come to an end.

A large part of the current budgetary adjustment is based on tax hikes rather than expenditure cuts. The government is currently executing a broad based expenditure review. Expenditure measures should be specified by March next year and have to make sure that the fiscal adjustment for 2014-15 will be based more on lower spending rather than higher revenue. If the government would be able to put the proposed expenditure cuts into legislation, this would lock in budgetary adjustments for years to come. But given the rise of austerity fatigue among the population and the declining popularity of the governing parties, this may well be rather challenging to achieve. We note that the two governing parties and the main opposition party have all committed to the macro-economic adjustment program with the troika. As such, signs of rising tensions in the governing coalition or a fall of the government would not immediately put the country away severely from the agreements with the troika. But significant political tensions or a collapse of the government will most likely preclude a full return to the capital markets.

Financial sector strengthened but still vulnerable

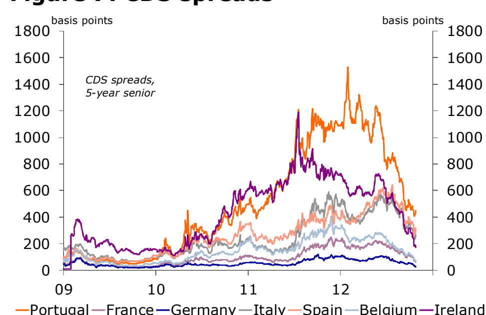
The Portuguese banking system received over EUR 7bn in fresh capital to comply with the European Banking Authority's requirements for core tier 1 capital ratio's to be a minimum 9% by the middle of the year and to be able to cope with losses in an economic stress scenario. Of the fresh capital, about EUR 5bn was provided by the state with the remainder coming from private investors. From the European/IMF funds, EUR 12bn has been earmarked for bank recapitalization. With EUR 5bn having been used, another EUR 7bn is still available for further capital support, should economic developments turn out worse than in the adverse scenario or losses exceed ex-

pectations for other reasons. Certainly, non-performing loan ratios are still rising due to the recession. High funding costs and the weak economy are also undermining pre-provisioning profits. The banking system is still largely shut out of the international capital markets and highly dependent on the ECB for liquidity and funding. The economy will have to stabilize and the government should have better market access for investor confidence in the banks to fully return. In any case, given that the banks have been an important intermediary in building up the large net foreign debt that the country as a whole has built up through years of high current account deficits, it will take years to fully deleverage and stabilize the financial sector.

Cautiously returning to market finance

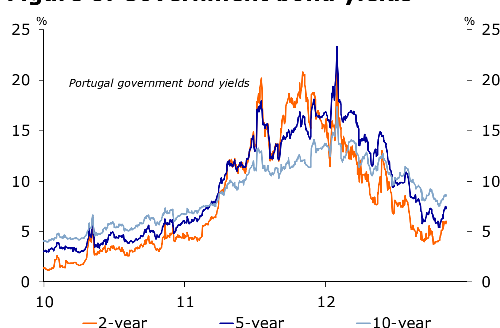
The government has up to now been successful in carrying out the planned austerity and reform as agreed upon with Europe and the IMF, including a recapitalization of the banks. The official financing has been forthcoming without delay as a result. The success of the adjustment program to date has helped reduce CDS spreads and yields for Portuguese government bonds. The fall in yields has been assisted by the formation of a pro-European government in Greece, which has reduced the risk of that country leaving the euro zone and with that has reduced contagion towards the Portuguese bond market. Also, the announcement by the European Central Bank that they are willing to buy government bonds of countries that are in a European rescue package and abide by the conditionality of that package has played a role in lowering yields. After a sharp inversion in the second half of 2011, the yield curve has normalized and is upward sloping again. Despite the more positive market sentiment, both CDS spreads and yields remain much higher than those of Spain and Italy (figure 7). Bond yields are currently still too high to return to market financing in a sustainable way (figure 8). And a recent renewed rise on the back of uncertainty about the next loan tranche for Greece shows that Portuguese bond yields are still susceptible to contagion from developments in other countries. They also remain much higher than those of Ireland. The Irish economy seems to have reached its trough and is fundamentally stronger than Portugal. But the Irish example does show that bond yields can reach sustainable levels a long while before all economic and financial problems are definitely dealt with.

Figure 7: CDS spreads



Source: Reuters EcoWin

Figure 8: Government bond yields



Source: ReutersEcoWin

The Portuguese government is financed by the rescue program until the end of the first half of 2013. Like in Ireland, Portugal is taking a step-by-step approach to return to the debt markets. It has been able to extend the maturity of treasury issuance to 18 months, successfully exchanged part of a bond maturing in September 2013 for a longer dated bond and recently issued a note with a maturity of more than 5 years. Yet even with the swap, EUR 6bn of long term bonds still mature in September 2013 and the increased financing needs due to the slower deficit reduction

path will have to be covered by treasury issuance. Compared to Ireland, which is fully financed under the rescue program until the end of 2013 and has reduced the bigger part of its bond redemptions in the first quarter of 2014, Portugal has a longer way to go back to the market but has less time to get there. If bond yields do not fall quickly enough over the next couple of months, additional official financing will be needed to prevent default. Risks that may prevent market access to be forthcoming quickly enough are not only related to the domestic uncertainties that we have discussed. Developments in the euro zone, related to the rescue package for Greece, the potential rescue package for Spain and further euro zone institution building to strengthen the currency union will all be important determinants of the Portuguese ability to regain market access.

Should market access not be forthcoming, a second rescue package will be needed. One option that could be used for this is to provide the country with a credit line from the European Stability Mechanism (ESM). This in combination with the ECB’s Outright Monetary Transactions (OMT) may well be sufficient to escort the country back to market based financing. Whether such a strategy will be pursued will depend on whether or not Spain will apply for such a program in the coming months. Should such a program be seen as successful, this will boost the credibility of the ECB’s announcement that it will do whatever is necessary to preserve the euro. This will in turn make it an important policy option for Portugal. On the other hand, if Spain eventually needs more financing and Italy is seen to need financial assistance as well, doubts may arise as to the size of the rescue funds as well as to the efficacy of OMT.

If the government is able to stick to the adjustment program as it has done to date, we expect additional financial assistance to be forthcoming relatively easily and without a debt restructuring. Even some minor deviations or modest political instability will probably not lead to a debt restructuring as part of further financial assistance. Only in case of severe deviations from the agreed austerity and reform do we think the troika will demand a debt restructuring before continuing with further financial assistance. Given the task at hand and the sizeable risks to the economic outlook such a scenario cannot be excluded. But we continue to regard it as a low probability event.

Conclusion

The Portuguese economy will remain in recession for some quarters to come. Economic rebalancing is proceeding much quicker than anticipated and the government has been successful in implementing the required austerity and reform. But years of austerity and reform lie ahead. This will be increasingly hard to implement and lead to more popular protests and rising tensions in the governing coalition. Many developments both in Portugal itself, in other euro zone countries and in euro zone wide policymaking can preclude a full return to the market at sustainable interest rates. The risk of default when the government deviates too much from the agreed agreements made with the troika is still present. But additional official financing will most likely be made available without a debt restructuring.

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	-1.7	-3.3	-2.2
Consumer prices (average % change pa)	2.4	2.6	-0.8	1.4	3.7	2.9	2.1
Current account balance (% of GDP)	-10.1	-12.6	-10.9	-10.0	-6.5	-1.2	-0.2
Economic growth							
GDP (% real change pa)	2.4	0.0	-2.9	1.4	-1.7	-3.3	-2.2
Gross fixed investment (% real change pa)	2.6	-0.3	-8.6	-4.1	-11.3	-13.3	-4.8
Private consumption (real % change pa)	2.5	1.3	-2.3	2.1	-4.0	-5.8	-2.8
Government consumption (% real change pa)	0.5	0.3	4.7	0.9	-3.8	-2.8	-3.0
Exports of G&S (% real change pa)	7.5	-0.1	-10.9	8.8	7.5	3.7	1.5
Imports of G&S (% real change pa)	5.5	2.3	-10.0	5.4	-5.3	-5.0	-0.6
Economic policy							
Budget balance (% of GDP)	-3.2	-3.7	-10.2	-9.9	-4.2	-6.1	-5.0
Public debt (% of GDP)	68	72	83	93	108	120	89
Money market interest rate (%)	4.3	4.6	1.2	0.8	1.4	0.6	0.4
M2 growth (% change pa)	8	15	6	10	5	-7	-1
Consumer prices (average % change pa)	2.4	2.6	-0.8	1.4	3.7	2.9	2.1
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	15.3	16.2
Balance of payments (m USD)							
Current account balance	-23516	-31852	-25597	-22813	-15438	-2600	-400
Trade balance	-26450	-33787	-24831	-24111	-18399	-9200	-7300
Export value of goods	52801	57871	44669	48905	59217	57800	60200
Import value of goods	79252	91658	69501	73017	77616	67030	67430
Services balance	8992	9733	8423	8832	10802	12500	12200
Income balance	-9632	-11442	-12179	-10423	-12024	-9200	-8600
Transfer balance	3574	3644	2992	2889	4185	3300	3300
Net direct investment flows	-2494	1908	1935	9962	-2186	1250	1000
External position (m USD)							
International investment position	-221550	-230021	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	443828	403451	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	665378	633472	n.a.	n.a.	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	-4.4	-3.5
Current account balance (% of GDP)	-10.1	-12.6	-10.9	-10.0	-6.5	-1.2	-0.2
Inward FDI (% of GDP)	1.3	1.9	1.2	1.2	4.3	3.7	3.0
International investment position (% of GDP)	-95.5	-90.9	n.a.	n.a.	n.a.	n.a.	n.a.

Source: EIU, IMF via Reuters EcoWin; the Economist Intelligence Unit estimates and forecasts for 2012 and 2013 do not necessarily represent Rabobank views and hence may deviate from the text

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