Portugal

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Portugal's successful recovery story is coming to an end leaving the country with moderate growth, low inflation but external and internal balances and reduced unemployment. However, deep legacy problems remain in terms of high leverage, weak banks and looming demographic problems while clouds are gathering anew in the global economy and the euro-zone.

Summary and conclusions

Growth slowing: After a strong performance following the latest euro-crisis the Portuguese economy has begun to trail. Last year activity slowed to a more moderate but still respectable 2.1% rate of expansion but for the current year most observers see only 1,7% growth as the external environment weakens. While consumer spending and investment demand continue at a reasonable pace, the drag from negative net exports will sustain into 2019 as the boom in inbound tourism fades. Low inflation will prevail and struggle to reach within the central bank's target rate of at least 1% pa. That will help to restore price competitiveness to arrest a weakening current account situation although still in overall balance.

Fiscal policies have remained prudent even in the current election year. Correcting for government sponsored rescue operations for banks the present socialist-led coalition has succeeded in containing the budget deficit within 1%/GDP since taking office in 2015. However, pressures are mounting against public sector wage freeze not least because the government has hiked general minimum wages more than inflation. Preparing for population aging and a workforce starting to shrink fiscal policy is imperative for the near future.

Outlook so far good although with qualifications: Predicated on a benign external environment, the government projects growth to continue at an annual rate of 2% for more years to come. Other observers are more cautious. Legacy problems abound, including excessive leverage for all sectors of the economy. At more than 120% the government debt/GDP ratio is the third highest in Europe, just behind Italy's, and private sector leverage exceeds those of other peers by a wide margin. On top of that come rising worries about the health of European integration now that the UK seems heading for a less than orderly Brexit and there are signs of longstanding disagreements between the euro-zones two political power centers being prised open now that the mediator – London – is falling out of the game. Should this battle for dominance be allowed to develop in a post-Brexit Europe, small countries, like Portugal could be caught in collateral damage.

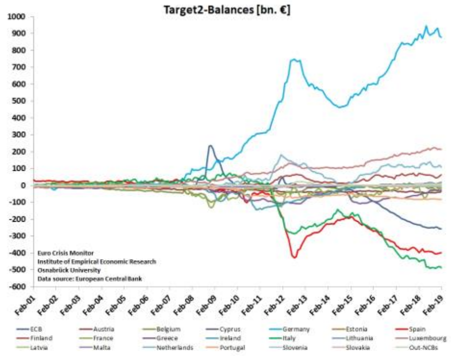
Ratings recovered: Over recent years, the rating agencies were quick to upgrade the sovereign to investment grade as it successfully recovered from the crisis, but they have stayed put since 2017. That may have a bearing on the rating of the country as well and more so when taking into account its legacy problems and associated vulnerability.

Recent developments

Growth start to trail: After a faster than expected recovery of recent years growth began to trail in 2018 ending the rate of expansion for the whole year some 0.7pp (percentage points) lower at 2,1%.   While domestic demand held up quite well net trade delivered a negative contribution as imports outpaced still buoyant exports by a wide margin.   That scenario s set to be much repeated in the current year. Private consumption continue steady growth on rising real household incomes on the back of tax cuts, rising social benefits and wages growing faster than prices. Investment demand, in turn, should quicken on easy financial conditions, more EU money for infrastructure projects and the need to replace and expand existing production equipment against a background of rising capacity utilization. However, net trade will continue to exert a drag on total demand and result a further deceleration of growth to some 1,7% according to most observers, almost half a percentage point below the government's own estimate which, admittedly, is based on a more optimistic external environment. Already in the first quarter growth turned out slightly lower than in the previous one.

Moderate inflation despite tighter labor market: Steady growth is now tightening the labor market. Last year the rate of unemployment fell to 6,7%, more than 10pp below its peak in 2013. That affected not only the more attractive job-seekers but also long time unemployed and youth. As a result, wages have begun to grow supported by the rise in statutory minimum wages by almost 5% a year and on average some 2pp above productivity growth.   That has so far had no meaningful impact on the overall consumer price pressure as measured by the CPI (consumer price index). Last year it moderated to 1% growth and expectations are that it will stay at that level for the current year as well. However, combined with a somewhat overvalued real exchange rate estimated by the IMF in late 2018 at 5-10% further wage raises could have consequences including for competitiveness. Home prices, by contrast, have been rising faster and have now completely recovered from their 18% drop after the GFC (Great financial crisis) of 2008-2010.

External balances treading water: Portugal's export performance over the last ten year have outperformed most peers in part due to unforeseen favorable developments. Those include a boom in inbound tourism as many alternative destinations for foreign holiday seekers were hit by deteriorating security situations. However, last year export growth fell sharply to 3,6% and it will probably continue to fall to only halve that growth rate number in the current year. Imports have also declined but less sharply with the result that the trade balance has remained in a significant deficit which is no longer likely to be fully offset by trade in services, including tourism.

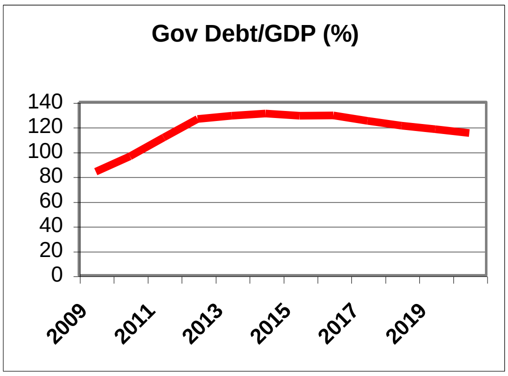


Capital accountThe current account balance, which began to turn out a yearly surplus after 2013, has essentially fell back to zero.   With significant FDI inflows (foreign direct investments) of last year and hefty loan repayments, including the last installment on the IMF-loan contracted in 2014, the total balance of payment probably ended with a small surplus also taking into Portugal's relatively stable TARGET2 balances of recent years -- a proxy for the monetary authorities' external balance within the euro-zone. That however, should not mask Portugal's deep external debt situation at 92% of GDP, mainly a legacy of large current account deficits of the more distant past.

Policies

Fiscal consolidation: Last year the fiscal deficit fell sharply to 0,7%/GDP because of one-off payments affecting the fallout for the preceding year when the government was forced to recapitalize two major banks to the tune of 2%GDP. For the current year the deficit target is 0,2%/GDP according to the Stability Program launched one year ago. Most observers, however, regard that target as unrealistic. After several years of wage freeze for public sector employees, underlying wage pressure is rising along with hikes in the statutory minimum wages and the government has already indicated willingness to yield on that and other fronts including the gradual introduction of the 35 hours week. The government is nevertheless basing its hopes on ongoing success in fighting tax evasion and an improved tax take in general to boost revenues. Pension reforms are also in the pipeline with an adjustment to the minimum retirement age indexed to remaining life expectancy.

Easy deficit financing despite still high government debt: Even with no major consolidation in the current year, financing of a deficit at par with the one for 2018 is not expected to become challenging. The cost of refinancing and new issues fell more than 50bsp in 2018 to1,5%pa while the government was able to stretch new maturity to more than 11 years, leaving the average at 8 years -- relatively long compared with peers. Although declining, concerns remain over high government debt levels, however. At more than 125%/GDP it is the third largest in the EU relative to size of the economy, and almost 40pp above the euro-zone average. Since 2013 it has stabilized and recently begun to narrow but from a high level, some three times higher than the average among rating peers, as pointed out by the rating agencies. In a short term horizon such concerns are tempered, though, by large government cash buffers amounting to some 40% of prospective 12 months needs thus enhancing the government's ability to manage shocks.



Structural issues

Stalling reforms: The broad reform impetus of the 2010-2014 period just after the GFC had peaked is now come to a pause as the economy has benefitted from a cyclical expansion. Actually, recent actions have been more focused on reversing past reforms. However, that position is soon to be challenged by adverse demographics and moderate levels of capital accumulation combined with a modest growth potential due to slow TFP (total productivity) growth and high private sector indebtedness. The European Commission (EC) estimates future GDP growth at only 1-1,5% in a medium term perspective and that is even predicated on some pick-up in labour productivity to offset the reduction of the working age population.

Banks are improving but not yet out of the woods:

Since some years worries have been rising over the health of the Portuguese banking system. Concerns about low profitability and high stock of NPL (non/performing loans) have not dissipated. That is despite government rescue operation for two major banks in 2017-18, the state owned *Caixa Geral de Depositos* and *Novo Banco,* the "good bank" rescued from the ruins of *Banco Espírito Santo* in 2014 and then sold in part to the US equity firm, *Lone Star*. However, these operations seem not to have ended there and *Novo Banco* is reportedly to receive a further €1.15bn capital injection from the country's bank resolution fund after posting a net loss of €1.41bn for 2018.

That said, there have also been improvements, including the return to profitability since 2017 of the banking system on average, a sharp decline in NPL to 11% in 2018 from a peak of 17% in 2015 of the loan book and not least a rise in banks own capital, as measured by the CET1 ratio, to 13% following more healthy loan growth and the recapitalizations cited above. Operating costs have also been addressed while by mid-2018 NPL coverage had improved to 53%,

High leverage: Doubts is still lingering, though, not least related to the banks' capacity to withstand a new economic downturn among their clients. Most of them are still deep in debt. Non-financial corporates (NFC) owe the equivalent of 140%/GDP to the financial system and household debt amount to 75%/GDP. Both ratios are much higher than in other euro-zone countries where debt/GDP hovers around 56% on average for households and 125% for NFC.

Macro-prudential measures: To mitigate the risks of such leverage the central bank has introduced several macro-prudential measures to discourage excessive loan growth. Value to loan (LTV) has been capped at 90% and DST (Debt-service/income) at maximum 50%, but none of the new measures very challenging compared to other countries in similar situations underpinning criticism that the authorities have shown slow progress on addressing banking sector issues.

Pursuing NPL resolution strategy: More acclaim has been received for the Banco de Portugal (BdP, central bank) for its new approach to solve the NPL problem including

- Legal and judicial reforms to remove impediments to NPL resolution
- Developing of a secondary market for troubled loans
- Tax incentives for debt restructuring and debt-to-equity swaps

These reforms have yielded positive results on resolution efficiency and finally on NPL resolution.

Politics

General elections are scheduled for next October. Since a narrow win in 2015, the Socialists Party has increased its voter support significantly over the main opposition party -- the Social Democratic Party -- and is now leading the polls with a margin of 9pp. So far that looks like a sure win for the socialist coalition which so far has proved more stable than expected when formed four years ago. Observers warn however, of the risk that the next parliament could end up more fragmented than the present and may not yield the needed support for prudent fiscal policies as excess confidence is building among policy makers with the potential for policy slippages. In return, the absence of populist/euro-sceptic parties may limit political risks although one should bear in mind that such movements can pop up at short notice.

Outlook

Steady improvements might still prove insufficient: There is no doubt that Portugal has made steady improvements since the peak of the global financial crisis. Record unemployment has dropped to a third, internal and external balances have consolidated while price pressure has been brought under control. Rapid growth during the recovery of recent years has been maintained but is now falling back to a moderate level more in line with regional peers. For 2020-2021, we project growth to remain around 1,5% -- its long term trend -- without a new impetus of continued reforms that could trigger private investment demand to expand real production capacity.

The trouble with such a development is that it still leaves the country vulnerable to dangers.

Firstly, the country is still encumbered with a very high level of legacy loans for all sectors of the economy – the government, the non-financial corporates and the households but such leverage is masked in the present low interest rate environment. That could come to a head should headwinds rise while banks are still struggling with low profitability and a too high level of bad loans still above 10%.

Second: The labor force is beginning to shrink. In a medium term scenario that can be compensated with higher participation rates but hardly for long. Adverse demographic trends are compounded by mounting pension liabilities thus facing Portugal with the same challenges as most peers but with a financially much weaker government.

Third: The external economy is changing and may no longer present the benign environment that has helped Portugal's stabilization after the GFC. Latest global trade volume data for the first three months of the current year looks like an ominous warning. German growth is flagging and China's growth is trailing although perhaps not as fast as feared by the end of last year.

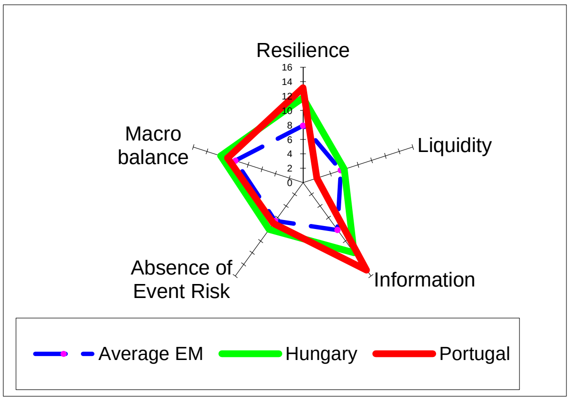
The main problem for Portugal may still be political developments in the euro-zone. Whatever happens over the next several months, Brexit has pried open a Pandora's' box of underlying political tensions in particular between Berlin and Paris. That could leave a small country like Portugal as collateral damage when the titans battle. (Box 1)

Box 1: *Who runs Europe?*

David Marsh of OMFIF (Official Monetary and Financial Institutions Forum) asks ***Who runs Europe, France or Germany?*** and notes that the two countries have different expectations but must come to terms with each other without the moderation of a third major economic and strategic partner, Britain. Further on: the most evident French reaction is relief that Brits are leaving a European project whose goal – full-scale integration – they could never support whole-heartedly anyway.

And it may be added: As to the crucial issue of who will succeed Mario Draghi next year as the ECB Chairman, France may now probably accept Jens Weidman in return for a Frenchman at the helm of the EC. But the euro-zone is still overly reliant on monetary policy to provide stimuli when needed, and in that Weidman is a hawk which could invoke investor fears of rate hikes which Portugal is hardly prepared for at this stage. for now.

Key ratios	**2019**
Population (mil)	10,3
GDP/capita ($)	23 873
GDP (change)	1,7%
Inflation	1,1%
Curr.Acc. Balance/GDP	0,1%
Reserves/imports (months)	1,4
Budget balance/GDP	0,1%
Government debt/GDP	138%



Sovereign ratings:

Fitch: BBB
Moody's: Baa3
S&P: BBB-

Peers:

India
Mexico
Hungary

Graph: Portugal scores well on *Resilience* and *Macro balance*. The *Absence of event risk* has increased as possible contagion from Greece has faded. The small number for reserves is strongly mitigated by Portugal's euro membership and the likelihood of an ECB-led rescue

Key data:	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP (bill.US$)	216	226	230	199	206	220	238	244	263
GDP/capita (US$)	20592	21641	22126	19268	19989	21371	23164	23873	25788
GDP (change)	-4,0%	-1,1%	0,9%	1,8%	1,9%	2,8%	2,1%	1,7%	1,4%
Investments/GDP	16%	15%	16%	16%	16%	17%	18%	18%	18%
Budget balance/GDP	0,0%	-4,8%	-7,2%	-4,4%	-2,0%	-3,0%	0,3%	0,1%	-0,3%
Govt debt/GDP	129%	141%	149%	149%	146%	145%	142%	138%	133%
CPI inflation (%)	0,0%	0,3%	-0,3%	0,5%	0,6%	1,4%	1,0%	1,1%	1,6%
Money demand (%)	-7%	-2%	0%	3%	8%	10%	6%	5%	4%
Stock prices	5199	6038	6385	5524	4737	5100	5372		
Interest rates	1,28%	1,33%	1,33%	1,11%	1,11%	1,13%	1,18%	1,18%	1,23%
Exch. Rate ($)	1,28	1,33	1,33	1,11	1,11	1,13	1,18	1,18	1,23
Trade/GDP (%)	61%	62%	63%	63%	61%	65%	68%	70%	71%
Oil price (Brent)	$112	$109	$99	$52	$44	$54	$71	$61	$66
Billions US $									
Export of goods	60,2	65,4	67,0	58,1	58,6	65,9	73,3	77,2	85,4
Imports of goods	70,9	74,5	77,8	67,0	67,4	77,7	87,8	92,7	101,8
Other:	6,1	12,5	11,3	9,6	10,3	13,1	14,1	15,8	16,9
Current account	**-4,6**	**3,4**	**0,4**	**0,6**	**1,4**	**1,3**	**-0,3**	**0,4**	**0,6**
Curr.Acc. Bal/GDP	-2,1%	1,5%	0,2%	0,3%	0,7%	0,6%	-0,1%	0,1%	0,2%
FDI (net)	17,1	3,9	3,6	1,3	3,6	9,3	4,4	0,6	0,6
Loan repayments	-0,5	-1,0	-2,2	-4,2	-7,0	-9,9	-7,6	-7,4	-8,1
Net other capital flows	-8	-5	-6	7	6	-3	10	6	6
Balance of payments	**3,5**	**1,3**	**-4,2**	**4,5**	**4,2**	**-2,1**	**6,4**	**-0,4**	**-0,9**
Reserves (bill $)	0,5	1,0	2,2	4,2	7,0	9,9	7,6	7,4	8,1
Total debt	519,1	525,9	510,3	437,3	430,6	479,8	471,1	515,9	548,6
o/w short term debt	168,0	176,0	166,0	148,0	125,6	161,1	145,0	158,8	154,2

Source: OEF (Oxford Economics) and SEB estimates.

Rating history

Fitch (eoy)	A+	A+	BB+	BB+	BB+	BB+	BBB
Moody's (eoy)	A1	A1	Ba2	Ba3	Ba3	Ba1	Baa3

Type of government: Parliamentary democracy

Next elections: Next Presidential elections 2021; Next legislative elections: 2019

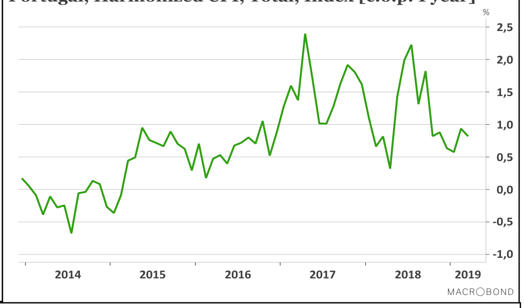
Other:

Latest PC deal: None

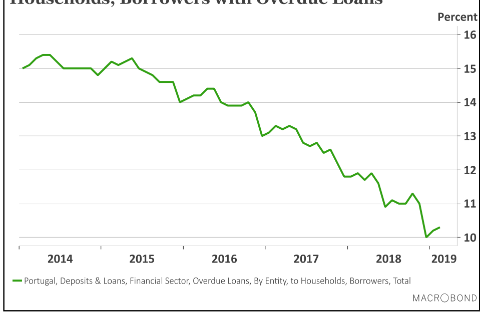
Recent IMF programs: EFF-program 2011-2014 for SDR24bn.

Portugal, Equity Indices, Russell, Global Developed Markets, All Cap, Index, Total Return, Close, EUR

Portugal, Harmonized CPI, Total, Index [c.o.p. 1 year]



Households, Borrowers with Overdue Loans



Portugal, USD, 5 Year, CDS, Mid

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