Eurozone

EY Eurozone Forecast

June 2015

Eurozone rebalancing toward broad-based recovery

Portugal

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Building a better working world

Outlook for Portugal

Faster growth of 1.7% seen in 2015, still led by domestic demand

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Highlights

- The recovery in Portugal that started in 2013 is continuing. GDP rose 0.4% on the quarter in Q1 this year and, following overall 2014 growth of 0.9%, we forecast growth of 1.7% in 2015, 1.5% in 2016 and then around 1.2% a year in 2017-19.

- Over the next couple of years, the expansion will be fairly broad-based, with growth of consumption and investment reinforcing the impetus from net external trade.

- Consumer prices rose 0.5% on the year in April 2015, the second month in positive territory, after 15 consecutive months of deflation. Energy and unprocessed food were the main factors behind the recent increase, but core inflation also rose. This confirms our view that Portugal will not fall into sustained deflation and, after an expected rate of 0.2% for 2015, a gradual rise in inflation is seen in the next few years.

- Low oil prices and low inflation should support purchasing power, but the existing slack in the economy will weigh on consumption growth. The unemployment rate remained broadly unchanged at 13.6% in Q1 2015, interrupting the steady downward trend that started in 2013, and it is still 5 percentage points above the pre-crisis level. We expect consumption to grow 1.3% in 2015 and then average just under 1% a year in 2016-19.

- Investment growth will also remain moderate due to high corporate debt. After a cumulative fall of 37% in 2009-13, investment rose by 2.5% in 2014 and we expect it to grow 2.6% this year and then 3% in 2016, before easing to just under 2.5% a year in 2017-19, underperforming most Eurozone peers.

- Portugal's solid trade performance since the end of 2014 is likely to continue in the medium term. The economy has undergone a major economic adjustment that has improved the competitiveness of its tradable sector. In addition, ongoing Eurozone recovery, low oil prices and the weak euro should ensure healthy export growth, more than offsetting lower exports (particularly to Angola, a major trading partner).

GDP growth

2015 1.7%

GDP growth

2016 1.5%

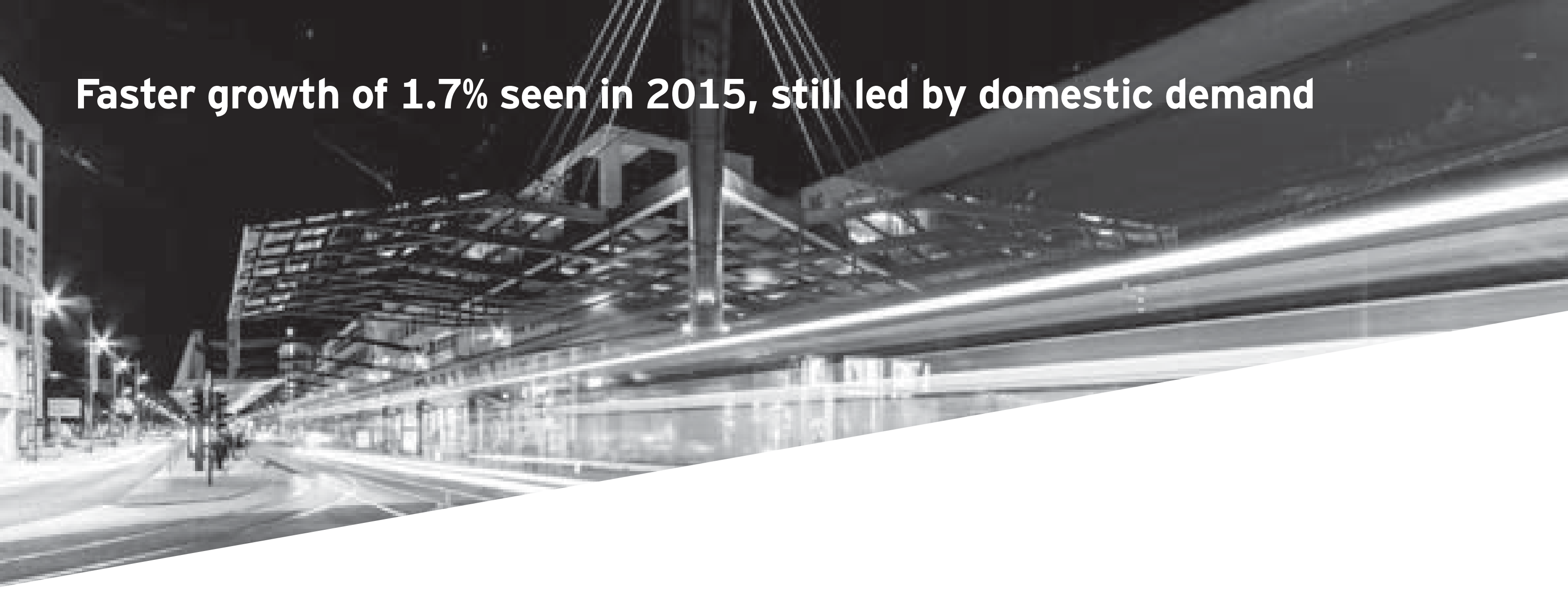
Unemployment

2015 13.0%

Consumer prices

2015 0.2%

Faster growth of 1.7% seen in 2015, still led by domestic demand



Growth is set to continue in the coming years

Portugal is set to continue the recovery that started in 2013. GDP grew by 0.9% in 2014 after three consecutive years of decline and the pace remained solid at the start of 2015. Q1 GDP rose 0.4% on the quarter due to the impact of lower oil prices and a boost to exports from the Eurozone's solid start to the year. We forecast GDP will grow by 1.7% in 2015, but, with domestic demand likely to remain constrained for some years by tight fiscal policy, high corporate and private indebtedness and existing slack in the economy, growth is expected to slow a little to 1.5% in 2016 and then to settle at about 1.2% a year in 2017–19.

Consumption to show some improvement

Consumption grew strongly in 2014, after three consecutive years of decline. In 2015, we expect consumers to benefit from another year of weak inflation boosting their purchasing power, with spending rising 1.3%. Nonetheless, the high levels of slack in the economy and private debt will continue to be a drag over the forecast horizon. We expect consumption in 2019 to still be 4% lower than the 2010 peak.

Confidence indicators are consistent in showing an improvement in consumers' situations. The consumer confidence indicator from Portugal's National Statistical Office remains at its highest level since August 2001. Similarly, the European Commission's indicator is at its highest level since Q2 2001.

However, Portugal's labor market remains fragile. The jobless rate fell rapidly in 2013 and the first three quarters of 2014. However, the improvement leveled off in the following two quarters, with the jobless rate of around 13.6% in Q1 2015 more than 2 percentage points above the Eurozone average and almost double the pre-crisis level. And while the unemployed total fell by around 130,000 between 2013 and 2014, only 70,000 new jobs were created in the same period, with the other 60,000 representing a decline in the labor force. And from the unemployed, around 60% are now long-term unemployed, a worryingly high level.

Low inflation will promote consumption due to higher purchasing power. Nonetheless, consumers will probably try to continue strengthening their financial conditions and restore their stock of savings, which were run down during the crisis, before starting to spend more robustly.

Table 1

Portugal (annual percentage changes unless specified)

	2014	2015	2016	2017	2018	2019
GDP	0.9	1.7	1.5	1.3	1.2	1.2
Private consumption	2.1	1.3	1.0	0.9	0.9	0.9
Fixed investment	2.5	2.6	3.0	2.5	2.4	2.4
Stockbuilding (% of GDP)	0.2	0.1	0.2	0.0	0.0	0.0
Government consumption	-0.3	-0.7	0.5	0.5	0.5	0.5
Exports of goods and services	3.4	6.0	4.7	4.7	3.8	3.0
Imports of goods and services	6.4	4.3	4.3	3.9	3.3	2.9
Consumer prices	-0.2	0.2	0.8	1.2	1.4	1.7
Unemployment rate (level)	14.1	13.0	11.7	10.8	10.3	10.0
Current account balance (% of GDP)	0.6	2.0	2.4	2.5	2.4	2.1
Government budget (% of GDP)	-4.5	-3.1	-2.5	-1.9	-1.4	-1.0
Government debt (% of GDP)	130.2	130.6	129.4	128.1	126.5	124.4
ECB main refinancing rate (%)	0.1	0.1	0.1	0.1	0.2	0.5
Euro effective exchange rate (1995 = 100)	123.9	114.4	113.1	113.3	114.7	116.2
Exchange rate (US$ per €)	1.33	1.11	1.07	1.06	1.09	1.11

Source: Oxford Economics.

After the expected rise this year, we still expect private consumption to continue to recover gradually, but at a slower pace of about 0.9% a year over the forecast period.

Investment growing, but constrained by high corporate debt

Investment started to recover in 2014 after five years of decline that saw the aggregate level fall by over 35% from 2008. This improvement was associated with an increase in business investment rather than housing investment, which declined for a sixth consecutive year in 2014.

Still, the recovery in fixed investment has been much more moderate in the current cycle than in previous cycles due to firms' high levels of debt. The debt-to-GDP ratio of nonfinancial corporations fell almost 10 percentage points in 2014, but, at 140% in Q4 last year, it remained one of the highest in the Eurozone.

Recovery in corporate investment should continue in the coming years, supported by firms' improving demand expectations, better financing conditions and pro-investment structural reforms, such as the recent changes to corporate income tax. After the steep drop in 2009–13, investment is estimated to have risen 2.5% in 2014. We expect it to rise by a similar amount in 2015 and then by around 2.6% a year in 2016–19, underperforming most Eurozone peers. Furthermore, the ongoing fiscal consolidation is expected to affect public investment, the ratio of which to GDP is seen stabilizing in the 2015 budget.

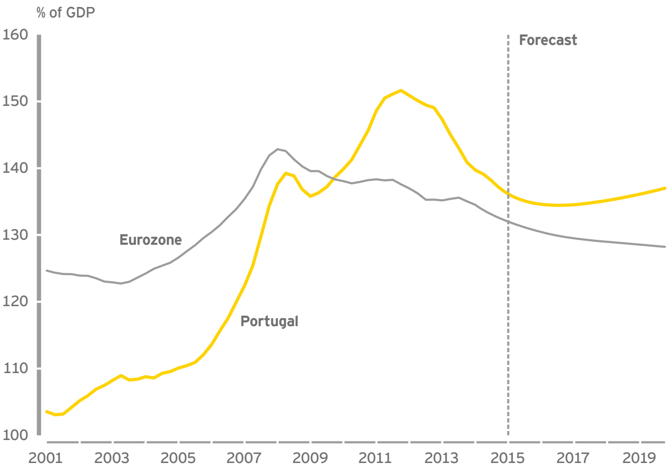
Net trade set to improve further

Similar to other Eurozone peripheral economies, Portugal has undergone a considerable adjustment of its external accounts. From a deficit equal to 12% of GDP in 2008, the current account was in surplus for the second consecutive year in 2014. In addition, low oil prices, the weak euro and the strong demand growth in Spain (Portugal's single most important trade partner) should ensure a healthy current account surplus this year — we expect it to rise to 2% of GDP from 0.6% in 2014.

We see this positive trend continuing in 2016, helped by the weaker euro, which has fallen by more than 20% against the US dollar since June last year. This should help Portugal's competitiveness with non-Eurozone economies, which in 2014 took around 30% of its merchandise exports.

Figure 1

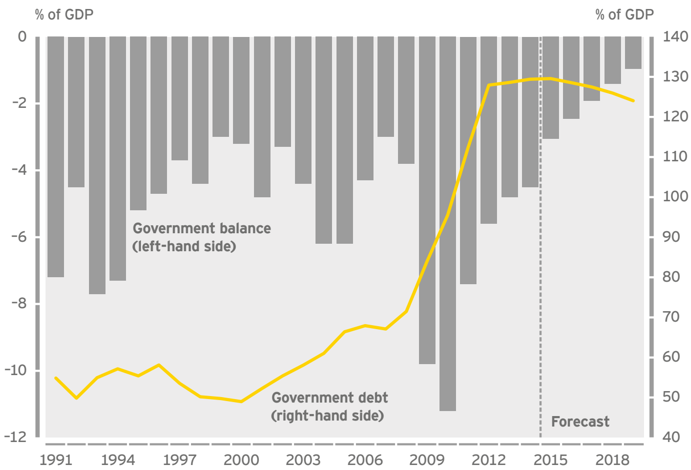
Corporate sector deleveraging



Source: Oxford Economics; Haver Analytics.

Figure 2

Government balance and debt



Source: Oxford Economics.

Table 2

Forecast for Portugal by sector (annual percentage changes in gross added value)

	2014	2015	2016	2017	2018	2019
GDP	0.9	1.7	1.5	1.3	1.2	1.2
Manufacturing	1.1	1.6	2.4	1.4	1.2	1.2
Agriculture	1.7	1.4	0.5	0.1	0.1	0.1
Construction	-4.0	1.0	1.2	0.8	0.7	0.8
Utilities	0.3	2.6	1.0	1.5	1.6	1.5
Trade	2.2	1.6	1.3	1.3	1.3	1.2
Financial and business services	-0.4	2.1	1.7	1.5	1.4	1.4
Communications	-2.1	2.2	2.3	2.2	2.2	2.2
Non-market services	1.3	-1.5	0.6	0.6	0.6	0.6

Source: Oxford Economics.

Faster growth of 1.7% seen in 2015, still led by domestic demand

Merchandise trade had a solid start of the year, with the trade deficit declining as imports fell (due to lower oil prices) and exports held up well as shipments to other European Union (EU) countries, in particular Spain, offset lower exports to Angola (Portugal's fourth main trade partner, but hit by weak oil prices). However, despite the favorable trends in merchandise trade, net exports had a disappointing first quarter, contributing negatively to GDP growth. But we still expect trade to make a positive contribution to growth in 2015 overall. Exports to Angola are expected to stabilize as oil prices start to pick up, while the weak euro and Eurozone recovery should ensure robust export growth elsewhere.

In addition, tourism should continue to provide a boost to services exports. The number of visitors rose by 11% in 2014 and this positive trend continued in early 2015, with a 12% growth rate registered in the first two months of the year. It is worth noting that there will be a 5% increase in the number of hotel rooms in Portugal this year, with the planned construction of 57 new hotels. Overall, we forecast export growth of 6% in 2015 and a modest slowdown thereafter.

Inflation to remain very low this year

After posting a 0.2% decline in 2014, annual inflation (on the EU-harmonized measure) rose to 0.5% in April this year, the fastest since mid-2013, confirming our view that Portugal will not fall into a deflationary spiral. The breakdown shows that the recent increase was caused not only by a pickup in energy and food prices, but also by an increase in core inflation. Assuming that oil prices remain around US$63 a barrel, Portugal will avoid a second year of deflation, with prices expected to rise 0.2% from 2014. Even so, inflation is expected to average just 0.8% in 2016 and will remain well below the European Central Bank (ECB) target level of 2% throughout the forecast period.

Corporate credit standards still weak, but improving

Last year, the financial system recovered from the first ever application of the EU's resolution mechanism to a leading commercial bank. The latest ECB lending survey shows that credit standards for nonfinancial corporations continue to improve. Bank interest rates for both mortgages and company loans are down by more than 30 basis points since the start of 2014, but remain high compared with the Eurozone average.

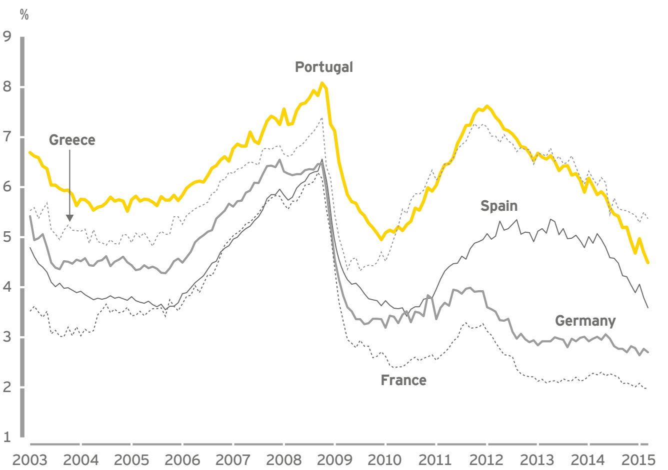
However, any improvement will come through very slowly, with credit constrained by weak profitability and an increasing level of bad loans. In Q2 2014 (the latest data available) the bad loans ratio was 11.2%, up from 9.2% in Q2 2012.

Subdued prospects in the medium term, with some risks

With its economy forecast to grow modestly, Portugal's most significant risk is the uncertainty around the threat of a Greek exit from the Eurozone and the resulting economic instability for the region, in particular for those countries that are highly indebted. However, the fact that Portugal has recently been able to access short-term funding at a negative interest rate for the first time ever, seems to indicate that the markets do not perceive this risk as high.

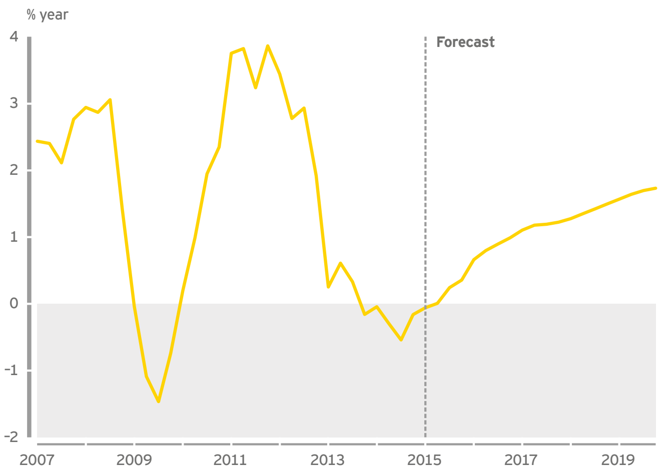
Meanwhile, there is an upside risk that consumer spending growth could exceed our forecast if the labor market continues to firm up more quickly than expected, which would reinforce the favorable impact of low inflation on real personal disposable incomes.

Figure 3
Typical interest rates on loans to businesses



Source: European Central Bank.

Figure 4
Consumer price inflation



Source: Oxford Economics.

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