Crédit Agricole Group economic and sector analysis

Prospects

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PORTUGAL – The country's momentum continues

- **Nearly ten years after benefiting from an IMF rescue package, Portugal is being reborn. Political stability and continuity, growth above potential, lower sovereign risk premia compared to Spain and Italy – Portugal is maintaining its momentum while major European economies are getting bogged down in the end of the cycle. The country seems to be immune to the economic hazards impacting the region. Initially supported by an export boom, the recovery has been under-pinned since 2018 by a sustained domestic trend. Despite the length of the recovery phase, the intensity of the post-crisis adjustment leaves room for recovery. That raises the question of whether the country could emancipate itself for much longer from a European and international environment tinged with gloom and subject to downside risks. Portuguese growth proved to be robust in 2019, still driven by a strong increase in investment. Consumer spending, which accounts for 66% of GDP, slowed from its peak in 2018 but stayed buoyant (+2.3%). The contribution from net exports turned negative under the combined effect of a slowdown in exports and continued dynamic growth in imports, supported by investment growth.**
- **The trend will likely remain comparable in 2020 with expected growth of 1.6%. Growth is therefore likely to move closer to its potential rate but will still be significantly higher than in other countries in the region.**
- **Consumption is expected to moderate as household disposable income slows amid low inflation. Due to less pressure on the labour market, wages are expected to continue to rise, but at a slower pace.**
- **Last November's elections strengthened Prime Minister Antonio Costa, who succeeded in getting the 2020 budget passed without a majority and without renewing the previous coalition. The government is expected to continue along the same political lines by maintaining the target of a balanced budget, yet it will still be forced to increase social spending after several years of austerity.**
- **The 2020 budget law targets a fiscal surplus of 0.2% this year following close to balanced public accounts in 2019. However, the budgetary target is based on an optimistic growth forecast of 1.9% and does not take into account the quota allocated to the recapitalisation of Novo Banco, which continues to drag down public finances.**
- **Public debt is likely to remain on a downward trajectory, closing the year at 119%. The low sovereign interest rates and the reduction of the risk premium on Portuguese long-term rates should also help to further reduce the debt service cost, thereby improving the Portuguese government's financing conditions.**
- **The current account balance is expected to remain slightly negative. Portugal's net international investment position, which remains a large deficit (-110% of GDP), is nevertheless expected to further decline as a result of increased FDI in the country.**
- **Private sector debt continues to fall, although it remains high (155% of GDP in 2018). The banking system is more robust but continues to have NPL rates above the European average.**

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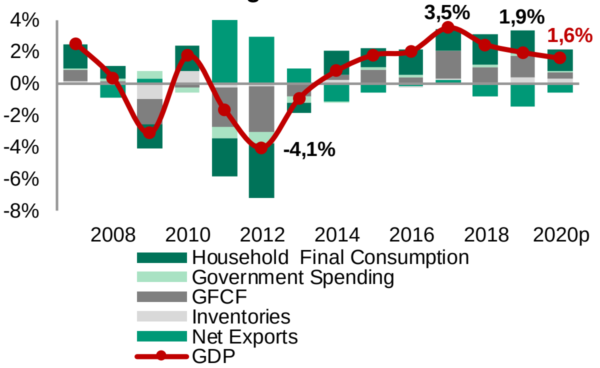
An end of cycle?

Despite some loss of momentum over the past two quarters, solid economic performance in 2019 (growth rate of 1.9%) still reflects the robustness of Portuguese growth. Since 2017, investment has been the main driver of economic activity with an average contribution of 1.4% over the last three years (out of average GDP growth of 2.6% for the period). Besides the positive effect of flows linked to European funds, GFCF has benefited from the rebound in productive investment and a timid recovery in the construction sector. However, public investment remains limited. Following two quarters of contraction in a row, this trend has shown signs of slowing since Q2 2019. This decline is expected to be temporary. An improvement in business confidence, along with the modest recovery in industrial output in November and December, suggests a rebound in GFCF at the end of the year. This upswing is likely to translate positively into 2020. Investment will nonetheless decelerate, with growth expected to reach 2.1% in 2020 (after 7.5% in 2019).

Portugal : contributions to GDP growth



Sources: Eurostat, Crédit Agricole S.A.

Private consumer spending eased in the first half of 2019 despite the low inflation backdrop, then strengthened gradually in the second half of the year. This poor start is also due to weaker growth in disposable income earlier in the year. This trend is expected to continue in 2020. As the catching-up process that took place between 2017 and 2018 fades, income growth in 2020 should be contained.

Public sector wage increases as part of the policy of unfreezing civil servants' salaries, pension readjustments and tax cuts will not fully offset the wage deceleration in 2020. Moreover, growth in consumer credit is expected to moderate. Strong credit growth in 2019 has led the Bank of Portugal to tighten the conditions for consumer loans.

The labour market is also showing signs of fatigue. Unemployment, which had reached 6.1% in Q3, increased by 0.6 points in Q4 2019. However, it remains at an all-time low for the year as a whole.

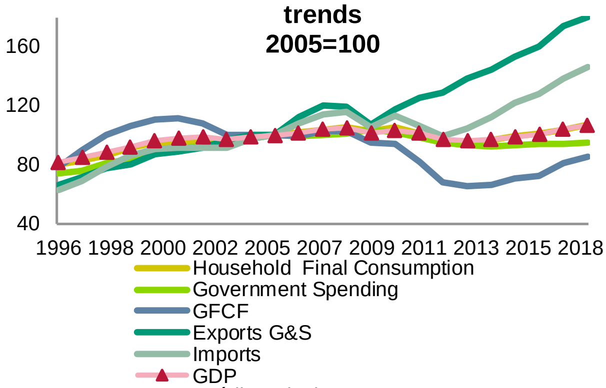
Our GDP growth projection of 1.6% in 2020 assumes continued momentum in the second half of the year, but it remains conservative and below the institutional consensus forecasts (government, Bank of Portugal, European Commission, OECD), that range between 1.7% and 2%.

Box: Exports, the engine behind the recovery

Between 2006 and 2018, exports of goods and services increased by more than 60% in volume terms. Their share of GDP increased by 15 points (44% of GDP in 2018). Even with the downturn induced by the crisis, exports made a positive contribution over the period. Of the 7% accumulated GDP growth between 2006 and 2018, 5.4% came from the external sector.

Portuguese exports have not only increased, they have also diversified in terms of partners and types of goods and services. Spain, France and Germany are still receiving 49% of Portuguese goods, but their relative weight has declined since 2006 (the three countries accounted for 54% of Portuguese exports then). This diversification has mainly been towards the east of the European Union, with an increase in export flows to Poland and Romania, but also the rise of new trade flows to the Czech Republic and Slovakia.

Portugal: Components of demand trends 2005=100



Sources: Eurostat, Crédit Agricole S.A.

While the increase in Portuguese exports is often associated with the tourism boom, it appears that the contribution of services was slightly less than that of goods (22.4% for services compared to 37.8% for goods over the 2006–2018 period). The agri-food and automotive sectors were the best performers, followed by intermediate goods sectors such as plastics and wood.

A rebound in car exports has appeared recently due to the ramp-up of the AutoEuropa (Volkswagen

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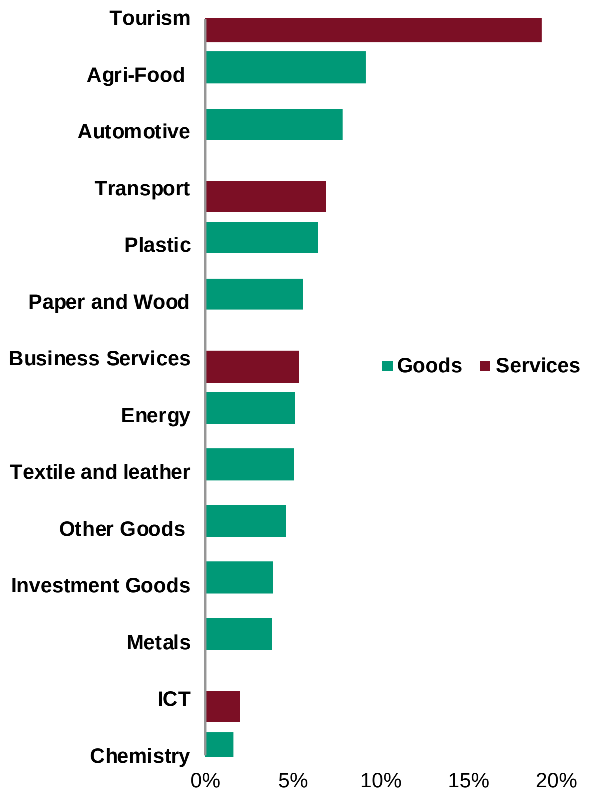
Group) site. Exports of services have also diversified and, although the strongest contribution comes from tourism, transport and business services activities have expanded. These developments reflect the greater internationalisation and openness of the Portuguese productive system, which has been able to take advantage of the crisis years to win market share abroad. Despite a relatively limited increase in productivity, the fall in production costs, especially unit labour costs, and an atrophying domestic market over the crisis have encouraged a two-pronged trend: a broadening of the base of Portuguese companies that export and the relocation of value chains into Portugal.

As a result, the share of revenue accounted for by exports at non-financial companies increased from 15% in 2006 to 22% in 2018. The number of foreign-owned companies also increased (+40%) even though they represent only a small portion of exporting companies. The contribution of FDI to exports remains lower overall than in comparable countries (Hungary or the Czech Republic), but is growing strongly, particularly under the impetus of public policies.

The openness of the economy has also come with shift toward quality. Using a methodology developed by the Bank of Italy, the OECD[1] has estimated the change in the qualitative content of exports in a panel of European countries. The study shows a clear change in the quality of Portuguese exports, which was particularly apparent from 2007 to 2015 (+1.6).

However, these achievements hide some weaknesses. Of the 52,000 companies that export, more than half are very small companies (fewer than nine employees) or export to just one destination. Following a challenging year in 2019, Portuguese's export sector is proving more resilient than expected. Exports grew over the year despite a drop in demand, but the 2017 peak is surely behind us. Export growth will likely decelerate further in 2020 but should pick up in 2021 as the downside risks to world trade dissipate. In that context, the rise in unit costs and loss of competitiveness will be the next challenge for Portuguese exporters if they want to preserve their market share.

Contribution to total export growth
(between 2006-2018 in %)



Sources: ITC trade, Crédit Agricole S.A.

Antonio Costa Act II

Portugal has stood out for political continuity and stability since 2015 and the elections of 6 October have confirmed that reputation. Antonio Costa's first term in office was praised by the international press and lauded by the rating agencies, but it was not all smooth sailing. Reactions within the country to his policies have been more mixed, especially following the "Tancos" affair, in which the defence minister was indicted in September 2019. Nevertheless, the former Prime Minister was able to ensure his continuity thanks to a tour de force: backing the economic recovery and at the same time restoring the country's credibility internationally thanks to a prudent fiscal policy.

[1] OECD., 2019. *OECD economic surveys: Portugal 2019*. Organization for Economic Cooperation and Development.

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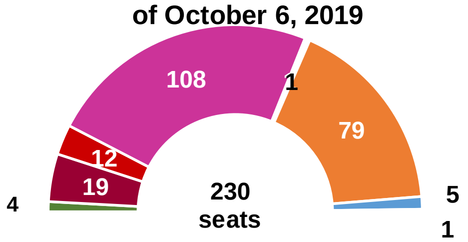
Portugal: election results of October 6, 2019



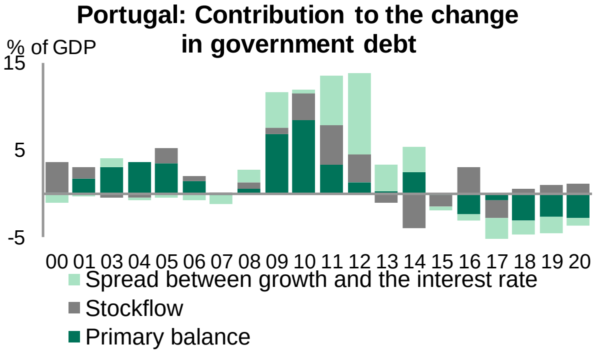
Source: Electoral Commission, Crédit Agricole SA

It was no surprise that Antonio Costa won last October's elections, despite a record 45.5% abstention rate. The Socialist Party gained strength with nearly 37% of the vote, giving it 108 seats. It does not, however, have a majority in the House. Meanwhile, the Social Democrats, the main opposition force, won 79 seats, while the left-wing bloc, a former member of the "Geringonça" (the name given to the outgoing coalition), maintained its 19 MPs. Thanks to higher numbers of MPs, the Prime Minister avoided having to renew the coalition with the left-wing parties, with which he had ruled during his previous term of office. His room for manoeuvre is, however, more limited as he has to seek consensus on a case-by-case basis. Even without a majority, the government managed to pass the budget vote by negotiating the abstention of part of the opposition. Presented to parliament on 16 December, the budget was passed on 10 January.

The Eurozone's star student

Following virtually balanced government books in 2019 (-0.1% of GDP), the new government is targeting a budget surplus of 0.2% in 2020. The primary balance surplus should therefore reach 3.2%, up from 2019. This target would allow the debt-to-GDP ratio to fall by 2.7 GDP points to 116.2% in 2020.

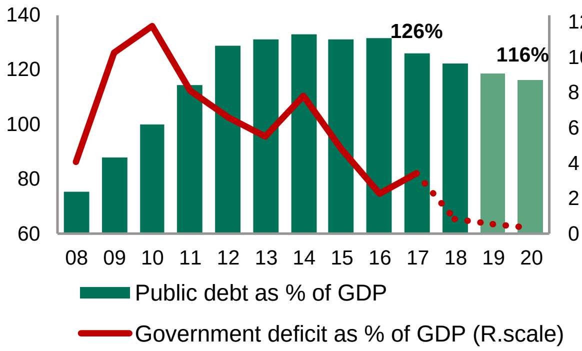
Portugal: Contribution to the change in government debt



Sources: Eurostat, Crédit Agricole S.A.

The 2020 budget remains conservative, but spending has been revised slightly upwards from 43.3% to 43.8% of GDP. Two measures should benefit from this increase: an additional allocation to health services, with €942 million to relieve hospital debt, and an increase in pensions and salaries in the civil service. Finally, €800 million will be injected into the Resolution Fund to support the banking system, €600 million of which will go to Novo Banco.

Portugal: Public finances
(in % of GDP)



Sources: Eurostat, Crédit Agricole S.A.

The 2020 budget is consistent with the previous coalition's policy guideline favouring a fiscally prudent approach and targeting a budget surplus. Yet, the left-wing opposition, which is calling for a greater fiscal effort vis-à-vis households and the civil service, increasingly contests this strategy. In a gloomy European environment, the targets set for the 2020 budget seem ambitious. Indeed, the government is projecting a 1.9% growth rate, driven by continued buoyant investment. This forecast is more optimistic than both the European Commission's and Portuguese Central Bank's outlooks, with the latter projecting a growth rate of 1.7%, which reflects the slowdown in the economy compared to 2019. We share the Central Bank's view, but our outlook is slightly lower (1.6% for 2020). At most, it would allow balanced public accounts. In addition, the fall in public debt would be slightly less marked (117% in 2020). The government should continue to profit from favourable financial conditions on the bond markets. ■

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