Eurozone

Ernst & Young Eurozone Forecast

Autumn edition – September 2011

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- Portugal
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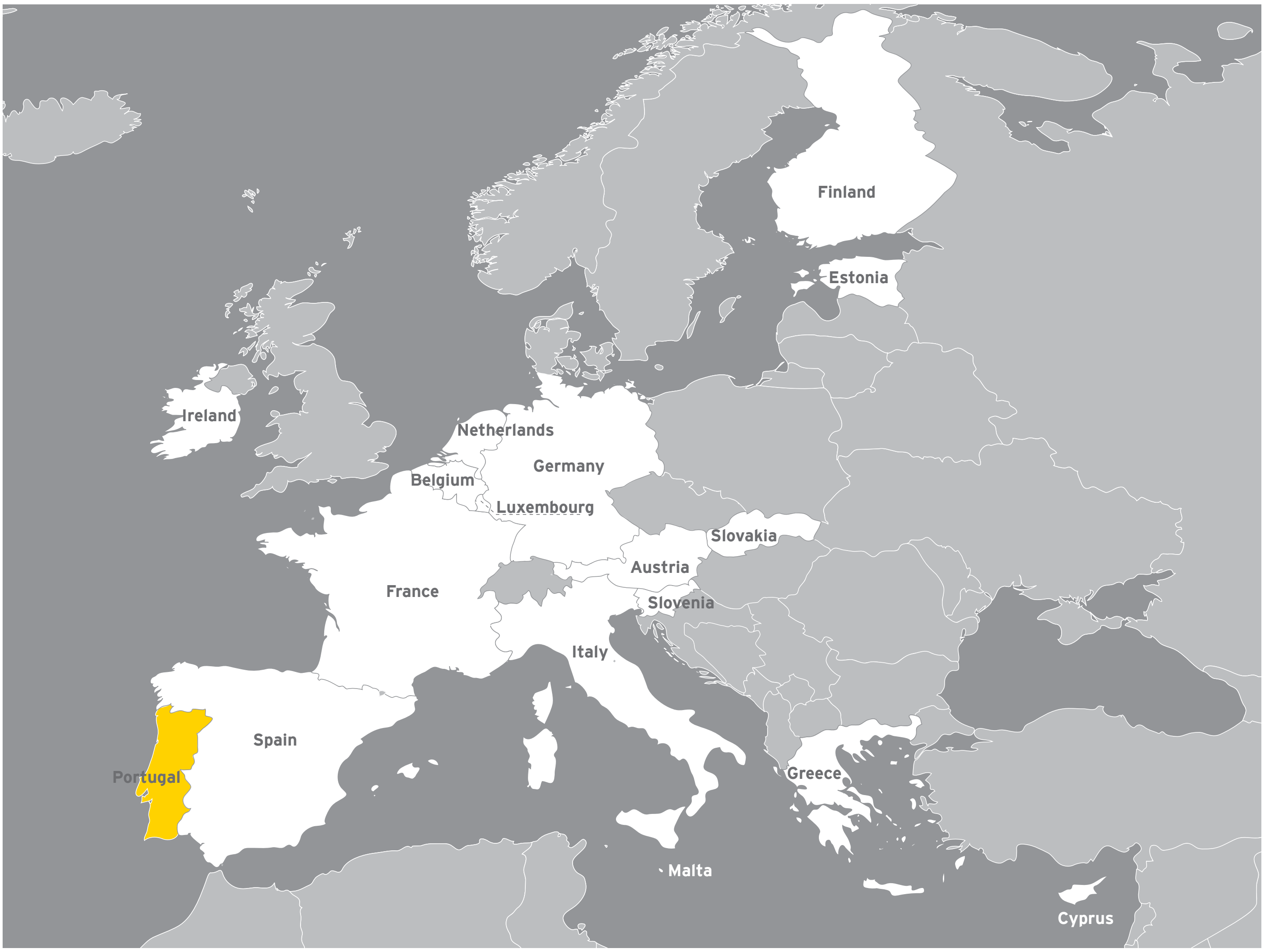
- Slovenia
- Spain

Ernst & Young
Quality In Everything We Do

Outlook for Portugal

17 Eurozone countries



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Highlights

Economic woes far from over, despite some traces of improvement

- Portuguese GDP remained unchanged in Q2 2011 compared with Q1, and declined by 0.9% on a year-on-year basis. Given the numerous headwinds the economy is currently facing, these results can only be viewed as positive and were underpinned by strong exports. Unsurprisingly, domestic demand remained subdued, with falls reported in both consumption and investment. Though exports are forecast to continue increasing, domestic demand is not expected to recover in the near future. Indeed, the recession in Portugal is likely to continue, and we expect GDP to decline by 2% in 2011 and 1.9% in 2012.

- According to the review completed by the European Union (EU) and International Monetary Fund (IMF) authorities on 12 August 2011, the Government remains on track to meet the conditions laid out in the Memorandum of Understanding (MoU). They concluded that the economy is on line to meet its fiscal target of reducing the budget deficit to 5.9% of GDP in 2011 (from 9.2% in 2010). Indeed, the Government has unveiled a further round of austerity, in order to make up for the budget slippage inherited from the previous Government in the first half of 2011. The authorities also acknowledged that the financial and structural reforms undertaken are credible, and have allowed for the disbursement of €11.5 billion to the Government.

- Despite encouraging steps taken by the Government to restore economic health, the credit rating agency, Moody's, downgraded Portugal's sovereign debt to junk status amid concerns that the economy will need additional rounds of financial assistance, possibly with an element of debt restructuring, before it would be able to access funding from financial markets.

- The banking sector, in particular, remains very fragile, with Portuguese banks being shut out from financial markets and having increased reliance on the European Central Bank (ECB). Although €12 billion from the bailout package has been earmarked for the recapitalization of the banking sector, banks' problems are likely to be exacerbated by the recent fall in equity markets, suggesting that the sector will need continued assistance and support for some time yet.

- The Eurozone debt crisis has escalated to new highs in the past couple of months, with tensions spreading to Spain and Italy, and heightened turmoil in financial markets. The Portuguese economy, currently struggling to resolve various issues in its domestic economy, remains highly vulnerable to these developments. While the economy has shown some signs of improvement in the past few months, the outlook remains fraught with various risks. Indeed, negative developments in the rest of the Eurozone may question the ability of the economy to return to capital markets in 2013, when the international money is due to run out.

Economic woes far from over, despite some traces of improvement

GDP stagnated in Q2 and medium-term outlook remains downbeat

Portuguese GDP remained unchanged in Q2 2011 compared to Q1, and declined by 0.9% on a year-on-year basis. Given the numerous headwinds the economy is currently facing, these results can only be viewed as positive and were underpinned by strong exports. Unsurprisingly, domestic demand remained subdued, with falls reported in both consumption and investment. We expect exports to continue increasing – rising by about 4.8% in 2011 – but, given the weakening of the core Eurozone economies such as France and Germany, risks to our forecast are on the downside.

Meanwhile, domestic demand is not expected to recover in the near future. Consumption fell by 0.7% on the quarter in Q2 2011 and we expect the rate of decline to accelerate in subsequent quarters. Higher taxes due to fiscal tightening and elevated inflation are damaging individuals' disposable incomes and consumer confidence remains depressed at record lows. Consequently, retail sales, that comprise about a third of consumer spending, declined by 1.7% on the quarter in 2011 Q2. Although unemployment (on the International Labor Organization measure) declined moderately to 12.3% (from 12.4% in Q1), it remains well above historical norms and is forecast to peak at 13.7% in 2013, before drifting down very slowly. These factors imply that consumption will fall both this year and next. We expect a decline of about 4.6% in 2011 and 3.5% in 2012.

Investment declined by 6% on the quarter in Q2 2011 and the outlook continues to remain bleak. Contagion resulting from the sovereign debt crisis in Portugal, as well as the wider Eurozone, is taking its toll on the banking sector. A decline in investor confidence implies that banks are unable to access funds from financial markets and are facing reduced levels of liquidity. According to the Bank Lending Survey conducted by the Central Bank of Portugal, credit conditions in Q2 2011 have become even stricter than the previous quarter, with bank's liquidity positions and access to finance influencing credit standards to an even greater extent than 2008. At the same time, companies' appetite to invest remains muted, and industrial production posted a quarterly decline in Q2 2011. Investment is, therefore, forecast to fall by 8.9% in 2011 and 3.0% in 2012.

Due to these factors, the recession in Portugal is likely to continue, with GDP expected to decline by 2% in 2011 and 1.9% in 2012.

Terms of bailout met so far ...

On a brighter note, the first review of the economy completed by the EU and IMF authorities on 12 August 2011 (since the country requested financial assistance in May), concluded that Portugal is on track to meet the conditions laid out in the MoU. The authorities acknowledged that, not only are the Government's efforts to satisfy the fiscal,

Table 1

Portugal (annual percentage changes unless specified) *Source: Oxford Economics*

	2010	2011	2012	2013	2014	2015
GDP	1.3	-2.0	-1.9	1.1	1.6	1.7
Private consumption	2.3	-4.6	-3.5	0.4	1.3	1.1
Fixed investment	-4.9	-8.9	-3.0	1.6	4.4	4.2
Stockbuilding (% of GDP)	0.0	-0.3	0.2	0.4	-0.1	-0.4
Government consumption	1.2	-5.2	-4.9	-0.6	0.1	0.9
Exports of goods and services	8.8	6.3	4.0	4.8	5.3	4.6
Imports of goods and services	5.1	-5.5	-0.2	3.3	3.8	3.6
Consumer prices	1.4	3.4	1.0	1.5	1.9	2.0
Unemployment rate (level)	12.0	12.7	13.5	13.6	13.4	12.9
Current account balance (% of GDP)	-10.0	-8.0	-6.9	-6.1	-5.5	-5.0
Government budget (% of GDP)	-9.1	-6.0	-4.4	-3.1	-2.8	-2.2
Government debt (% of GDP)	93.0	99.7	104.9	105.8	105.3	103.9
ECB main refinancing rate (%)	1.0	1.3	1.2	2.6	3.5	3.9
Euro effective exchange rate (1995 = 100)	120.7	121.1	120.4	119.4	115.4	113.5
Exchange rate ($ per €)	1.33	1.41	1.38	1.33	1.27	1.24

financial and structural conditions credible, they will be further supported by the more relaxed terms of the bailout agreed at the EU summit held on 21 July 2011, when finalizing the second financial aid package for Greece.

Indeed, the interest rate to be paid on EU loans has been reduced to 3.5% (from 6% and 5% for 10-year and 5-year loans respectively) and debt maturity has been raised from 7.5 years to at least 15 years. These changes will be beneficial for Portugal's public finances, and market reaction to the deal remained positive.

… but sovereign debt downgraded to junk status

Despite the Government's increased efforts to restore the health of the economy, the credit rating agency, Moody's, downgraded its sovereign debt to junk status from Ba2 to Baa1 with a negative outlook. This was amid concerns that the economy will need additional rounds of financial assistance, possibly with an element of debt restructuring, before it would be able access funds from financial markets. In addition to the increased risk of private bondholders having to bear the losses of further financial help, the agency expressed doubts over the country's ability to meet the ambitious fiscal targets outlined in the MoU. Financial markets' reaction was adverse and Portuguese bond yields rose to new highs, with 2-year and 3-year bond yields rising above 20% and 10-year bond yields above 13%.

Portugal's banking sector, in particular, remains fragile. Contagion from the debt crisis has caused Portuguese banks to be shut off from financial markets and their dependence on the ECB — which recently resumed its bond-buying program — remains significant. Although €12 billion in the MoU has been earmarked to recapitalize the banking sector, banks' problems are likely to be exacerbated by the recent fall in equity markets, suggesting that the sector will need continued assistance and support for some time yet.

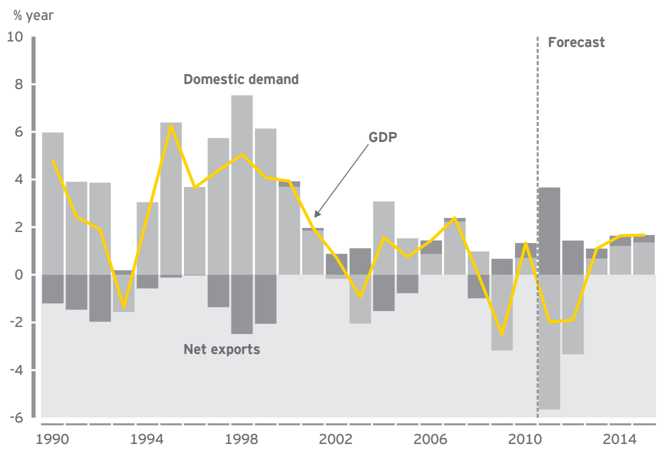
Fiscal targets impose yet more austerity …

The review concluded that the Government is on track to meet the fiscal target of reducing the budget deficit to 5.9% of GDP in 2011 (from 9.2% in 2010).

The center-right Social Democrats, (the party that recently came to power in early June) have inherited a budget slippage of about 1.1% of GDP from the previous Government, and the budget deficit improved only moderately in Q1 2011. They have, therefore, announced a further round of austerity measures, which include a 50% tax on year-end salary bonuses as well as spending cuts, that together account for about 1% of total GDP. These measures come on top of strict austerity measures already announced over the past couple of years and are likely to be a drag on growth.

Figure 1

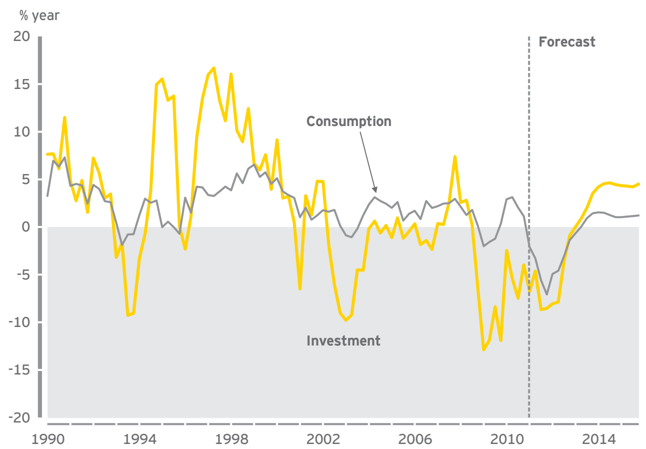
Contributions to GDP growth



Source: Oxford Economics

Figure 2

Consumption and investment



Source: Oxford Economics

Economic woes far from over, despite some traces of improvement

… and satisfactory progress on financial and structural front …
The review acknowledged the significant efforts made in the banking sector in order to strengthen banks' balance sheets to meet the capital requirements of raising their core tier 1 capital ratio to 9% by end-2011 and 10% by end-2012.

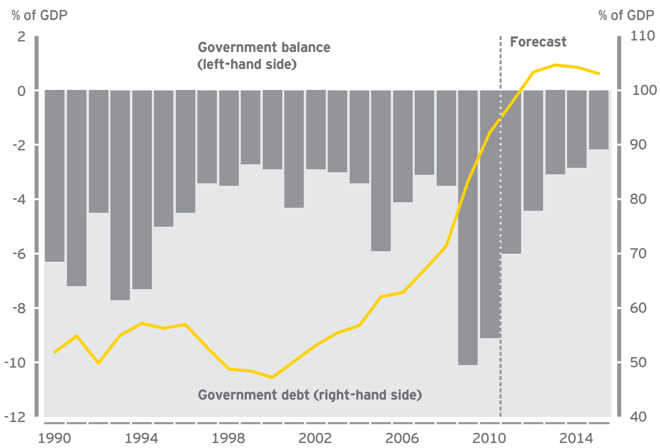
Finally, structural reforms that involve reducing the Government's involvement in private sector activity to boost Portugal's competitiveness are under way. Raising the economy's competitiveness remains of utmost importance and is perhaps the key aspect that will restore the economy to health in the long term. In this regard, the Government has abolished the special rights of the state in private companies ahead of schedule. Labor market reforms are also advancing.

As a result, the next tranche of €11.5 billion of aid payment has been disbursed to Portugal from its €78 billion bailout package. It is worth noting, however, that the authorities highlighted the significant challenges Portugal faces in the coming months, especially the severe opposition the Government is likely to face (both from the opposing political party and the Portuguese people) in its efforts to meet its fiscal, financial and structural targets.

… although negative developments in Eurozone pose downside risks to growth
The Eurozone debt crisis has escalated to new highs in the past couple of months, with financial tensions spreading to Spain and Italy and heightened turmoil in financial markets. The Portuguese economy, currently struggling to resolve the issues on its domestic front, remains highly vulnerable to these negative developments in the Eurozone.

We believe that, while the economy has shown some signs of improvement in the past few months, the outlook remains fraught with various risks. Indeed, negative developments in the rest of the Eurozone may question the ability of the economy to return to capital markets in 2013, when the international money is due to run out.

Figure 3
Government balance and debt



Source: Oxford Economics

Figure 4
Bond spread over Bunds

Source: Haver Analytics

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