Portugal:
Macroeconomic and financial outlook

BPI *Research*

June 2022

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BPI Grupo CaixaBank

Main messages

Activity

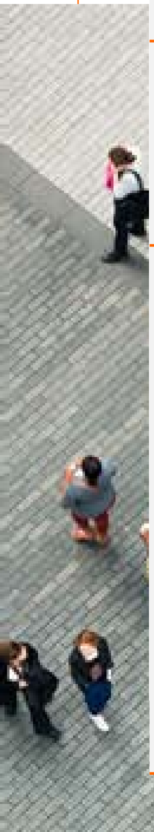
- **Strong growth in Q1 22 driven by private consumption, tourism and investment. These figures led us to upward revise current GDP growth forecast in 2022 to 6.6% from 4.2%.** Despite the strong uncertainty surrounding the current scenario, we consider that risks to our prediction are balanced as they already include a considerable slowdown on next quarters' growth, reflecting the persistence of bottlenecks, higher inflation and the expected increase of interest rates.
- **The conflict significantly increases inflationary pressures.** In May, inflation stood at 8,0% and we expect a moderation during the second half of the year. **However, given the recent behavior, we revised upwards our forecast for inflation in 2022 to 6% from 5.4%.** Risks continue skewed to the upside.
- **Fitch Ratings Agency maintained the BBB rating to long-term public debt, but improved the outlook to positive,** reflecting that "better-than-expected fiscal performance relative to comparable peers and strong economic recovery have put public debt-to-GDP back onto a firm downward trajectory". Despite the high level of uncertainty, Fitch considers that medium-term prospects for growth are positive, taking advantage of NGEU funds. Still, Portugal is less exposed to the war in Ukraine than other EU countries, given the low reliance on Russian energy (Russia accounted for 4.9% of Portugal's imported energy needs in 2020, vs 24.4% in EU). Even so, high energy prices will weigh on growth.

Banking sector

- **According to Fitch, main indicators performed well during the pandemic**, with the total capital ratio improving to 17.9% in 2021, from 16.6% in 2019. Non-performing ratio declined to 3.5% in 2021 (vs. 5.7% in 2019). The Portuguese banks have very limited exposure to Russian counterparts, around USD170 million, according to Fitch. However, second-order effects from risks of lower eurozone and Portugal's economic growth, rising inflation and eroding economic sentiment could weigh on the banks' profitability prospects over 2022-2023.

Policy

- **The State Budget for 2022 proposal was approved, as expected.** The focus continues on the consolidation of public accounts apparent in the expected reduction of the public deficit to 1.9% of GDP from 2.8% in 2021 (which surprised favourably, compared with -4.3% target).
- **The Government adopted a set of measures to limit the impact of higher energy prices due to the war in Ukraine, equivalent to 1.6 bln euros (0.7% of GDP);** from these we highlight: €20 refund for refueling (autovoucher) until end-April; suspension of the increase of the carbon tax; reduction of tax on oil products; monthly support to most vulnerable families; credit lines to sectors most affected by rising energy costs.
- **Despite the strong support to the economy, the fiscal deficit and public debt are declining.** In 2021, fiscal deficit stood at 2.8% of GDP (5.8% in 2020) and public debt declined to 127.4%, -7.8 p.p. than in 2020. This positive trend is expected to continue, but public accounts will face several challenges in the near future, some of them related with the new measures to fight negative impacts of the war in Ukraine for households and companies. Nevertheless, there is room to accommodate potential fiscal slippage as the economy is showing strong dynamics and as public debt increased comparatively less in 2020 than in other European peers.
- The Government public funding needs will be less covered by ECB purchases in 2022 than in 2020-21, but ECB acquisitions will continue to be an important support, (expected to cover around 20% in 2022). Still, the Treasury liquidity cushion amounts to circa €23 bln (≈10% of GDP).



GDP: strong growth in Q1 22 and positive Q2 data behind upward revision of annual growth

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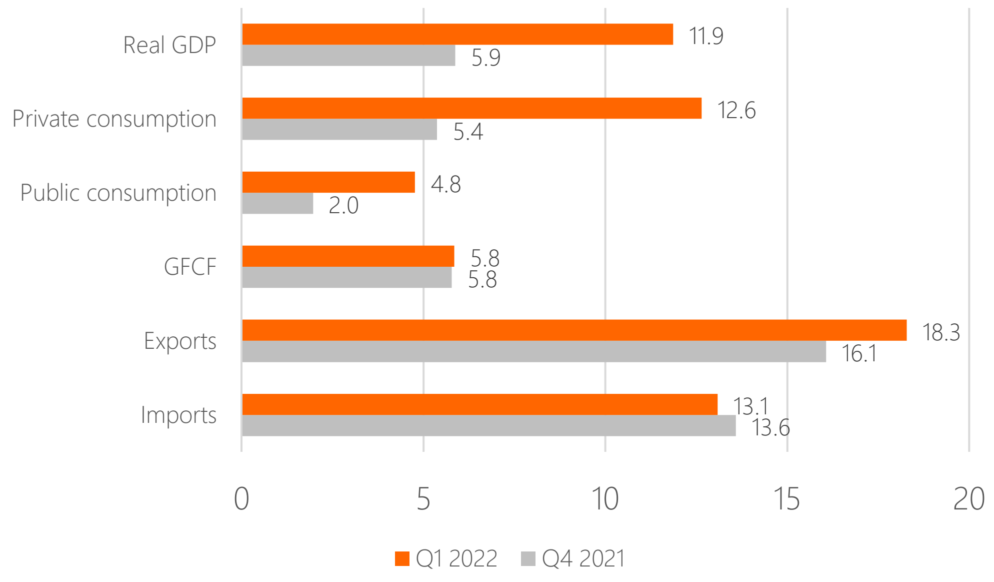
GDP recovers pre-pandemic levels

Dec 2019 = 100

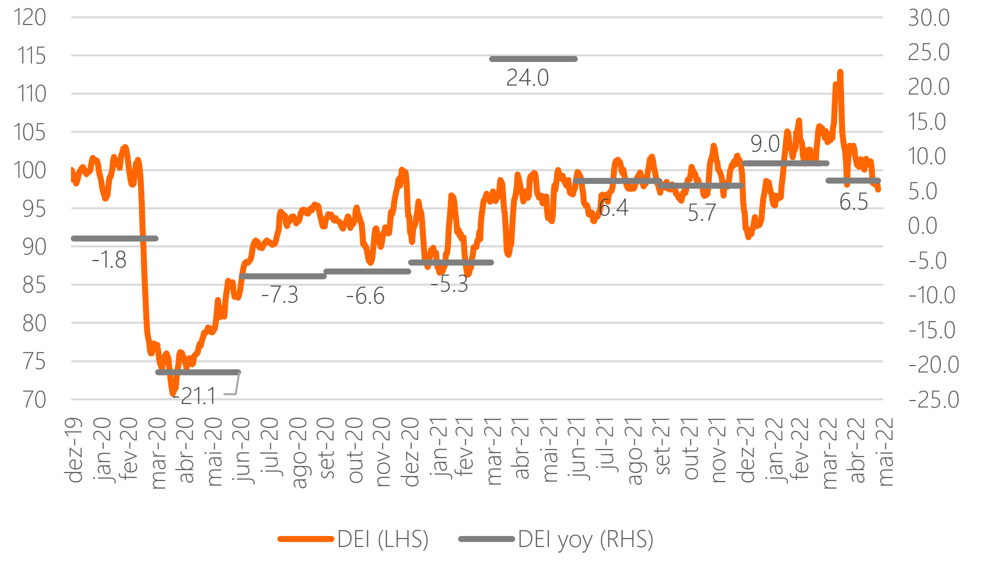


***Source**: BPI Research, from INE.*

Daily economic indicator

Dec 2019 = 100

yoy



***Source**: BPI Research, from BoP.*

- **In 1Q22, GDP grew by 2.6% qoq and 11.9% yoy and exceeded in 1.2% the 4Q 2019 level.** Private consumption and tourism recovery were the drivers of growth, but investment also performed well. Domestic demand contributed with 10.1 percentage points to the year-on-year growth and foreign demand with 1.7 p.p..
- **In the meantime, most high frequency data suggests that activity continues to expand in Q2, albeit at a slower pace.** The daily economic indicator points to a deceleration but continues comfortably on positive field; payments with electronic cards continue to indicate solid consumption; and economic sentiment indicators remain at comfortable levels, besides the decline seen in April and May; finally, tourists surpassed the pre-pandemic levels for the first time in April.
- **Despite the persistence of high uncertainty, we upward revised annual 2022 growth to 6.6%, from 4.2%.**

The impact of higher energy prices is heterogeneous among sectors

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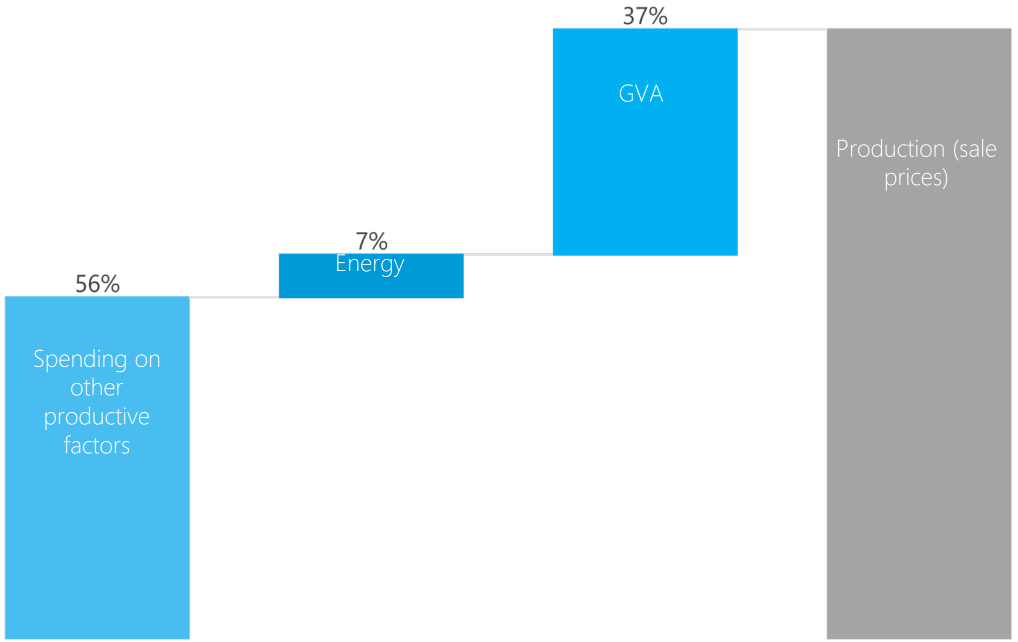
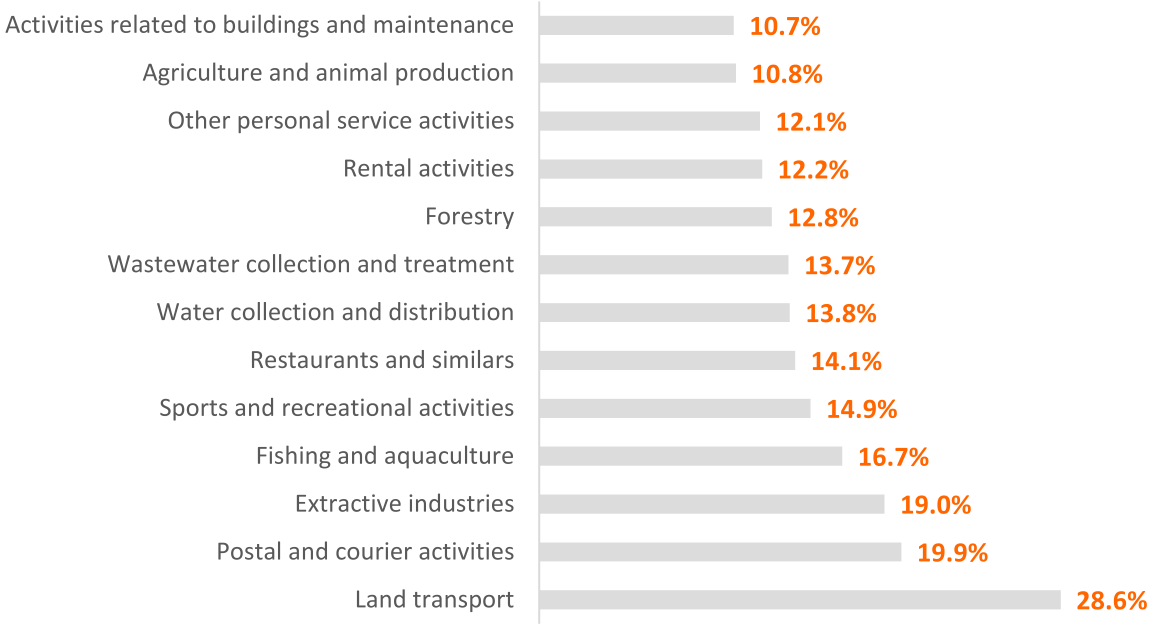
National accounting structure by sector
% of production



Weight of energy costs
% of the total production of each sector

Total economy: 7%

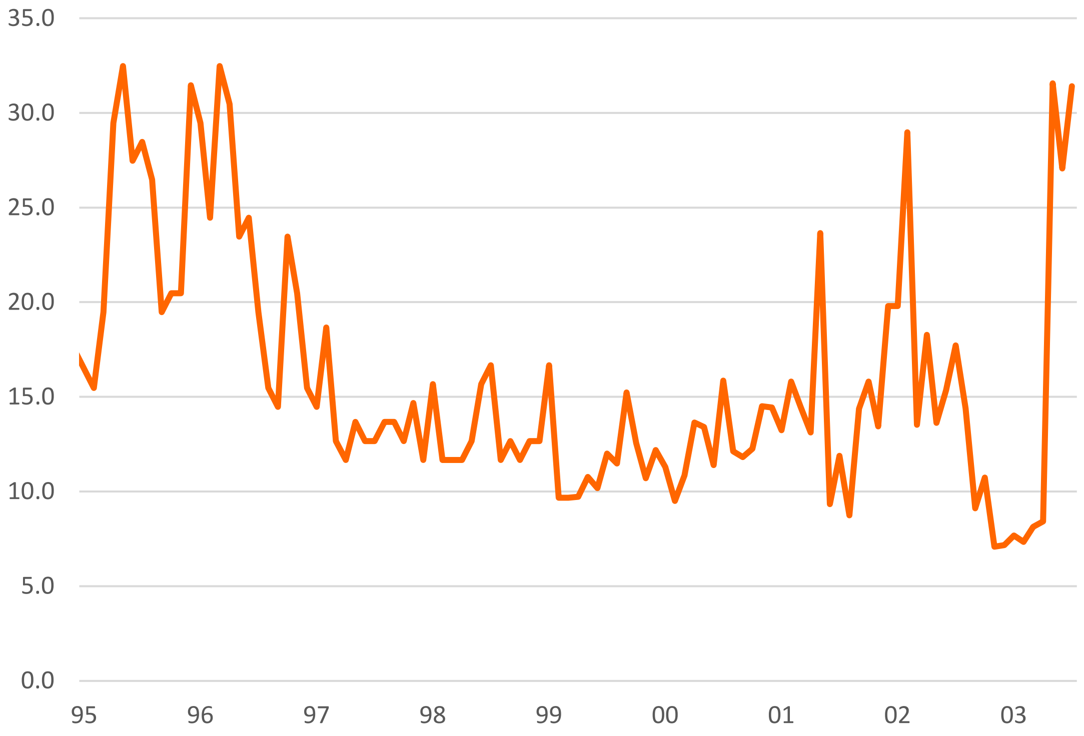


***Source**: Caixabank Research, from INE.*

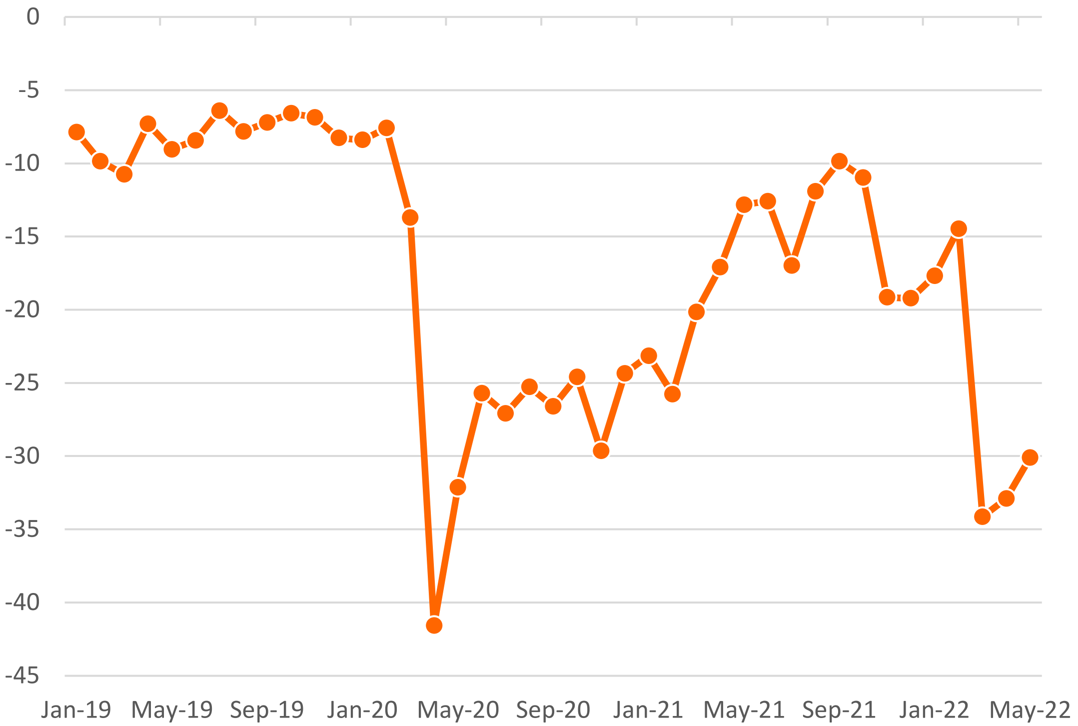
- **The war has caused a shock in energy prices, but also in the prices of other raw materials such as industrial metals** (Russia is a key producer at a global scale) and **agricultural products** (Ukraine is one of the main exporters of cereals in Europe). The exposure of the Portuguese economy to price increases in these products is highly heterogeneous across sectors.
- On average, costs with energy correspond to 7% production. However, **the impact of higher prices in energy is very diverse among sectors.**

Conflict in Ukraine affects confidence and pressures inflation

Confidence surveys: obstacles to the activity in industry - shortage of raw materials
Level



Consumer confidence
Level



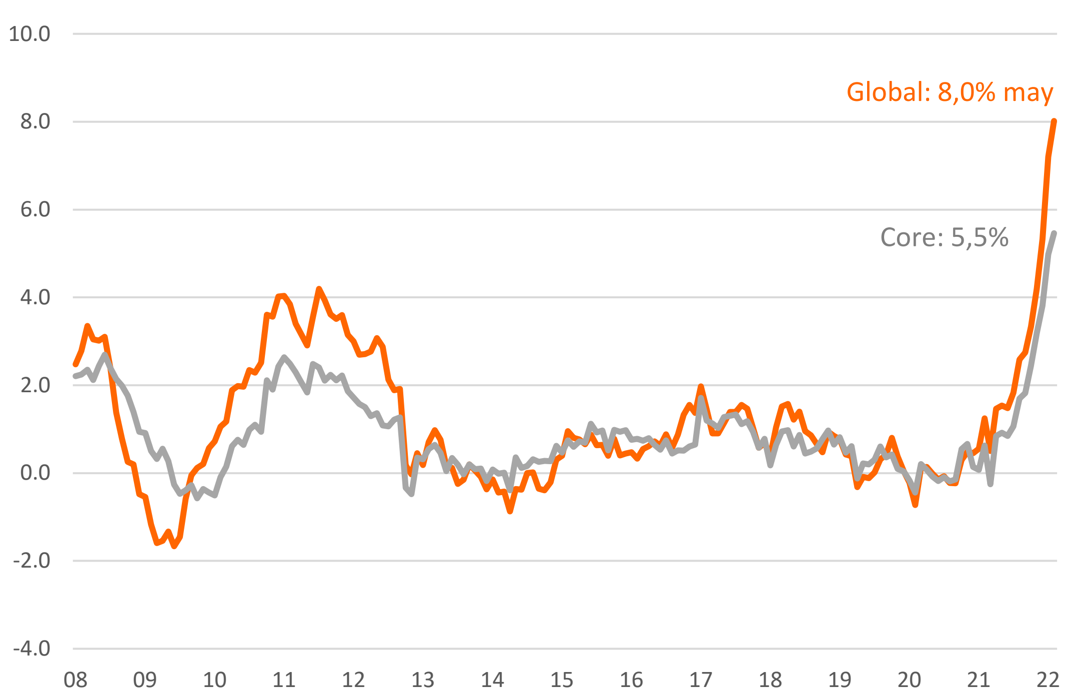
Source: *BPI Research, from INE.*

- **Shortage of raw materials continue to be referred as an important obstacle to activity,** raising risks to the supply side of the economy**.** Manufacturers continue to report the lack of inputs as one of the main constrains to production.
- **Consumer confidence slumped in March, but improved slightly in April and May.** High inflation, concerns about labor market performance and about the economic situation of the country are the main issues curbing consumers sentiment.

Inflation accelerates to 8,0% in May, a maximum since 1993

The global and core inflation

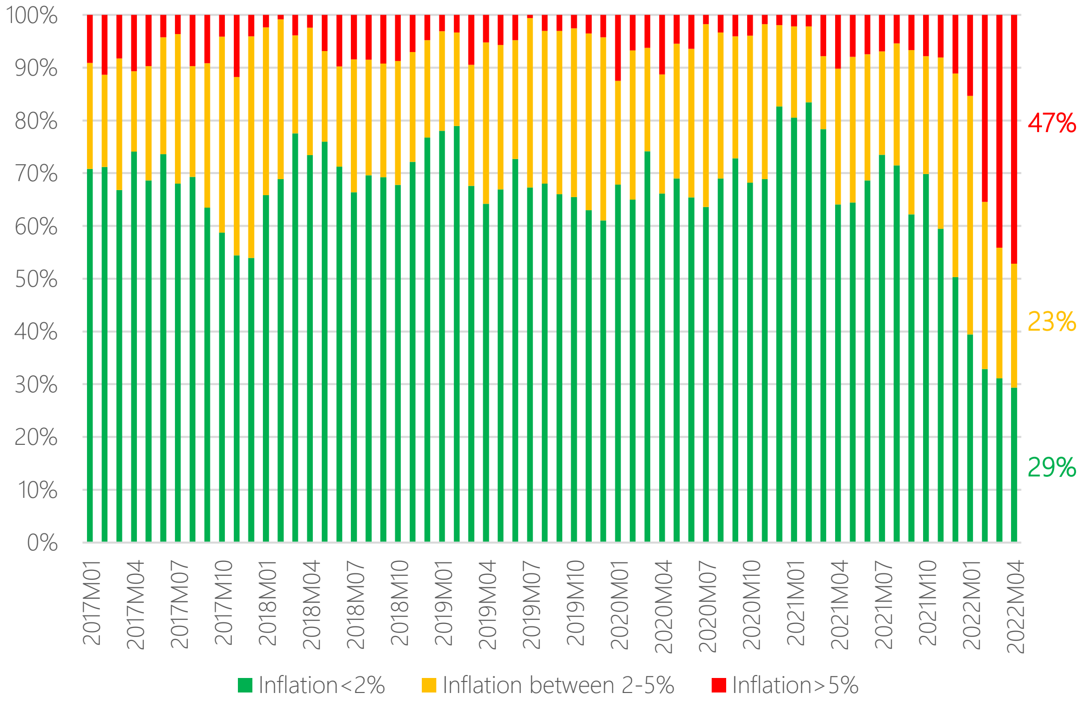
Year-on-year (%)



Source: *BPI Research, from INE.*

The inflation traffic light

% of CPI basket



- **Inflation accelerated again in May** to 8.0% (7.2% in Apr.), driven by higher prices on energy component and non-processed food (detail still not available). Additionally, high energy prices started to spread to other components (processed food for example), intensified by the impact of scarcity of inputs in a period of higher demand. Core inflation accelerated to 5.5%, from 5.0% in April. **Inflation should decelerate in the second semester**, reflecting a deceleration in energy prices and reduction of supply bottlenecks in the last part of the year. However, there is strong uncertainty regarding the pace of moderation in consumer prices and the recent behavior led us to revise upwards annual inflation to 6.0% from 5.4%. **Risks continue tilted to the upside**.

The government unveils a fiscal package to cushion the impact of the war

The fiscal package will have a direct cost of €1.6bn euros (0.7% of GDP), includes €0.5bn in credit lines

To cushion the impact on households

- **Most vulnerable families:** support of €60 in order to mitigate increase of prices of basic necessities + support of 10€/month to acquisition of bottled gas. Estimated tax cost: €55 mln.
- AutoVoucher - Reimbursement of 40 cents/lt of fuel, up to €20/month (march and April). Estimated tax cost: €133 mln.
- Reduction of tax on oil products equivalent to a cut of VAT to 13% and fiscal neutrality. Estimated tax cost: €287 mln/month.
- Temporary suspension of the carbon tax. Cost: €360 mln.
- Reduction in tariffs for access to electricity networks

Sector related measures

- **Agriculture and livestock**: reduction or exemption of oil tax on agriculture oil; support to mitigate increased costs with animal feed and fertilizers. Total €65 mln. Lines of credit: for the swine and milk sectors: €9 mln; for dry support: €50 mln.
- **Transport sector**: support to mitigate impact of higher fuel prices (30 cents/lt). Cost: € 75mln. Support to public transports.
- **Gas intensive industries**: grants to support companies' rising gas costs; non-refundable support covering 30% of the difference between costs incurred in 2021 and those incurred in 2022 (max €400 mil/company): € 160 mln
- Flexibility of tax payments and SS contributions to the most vulnerable sectors: agriculture, fisheries, transport, textiles, pulp manufacturing, ceramics and glass industry, steel, cement production and the chemical industry.

Sector related measures

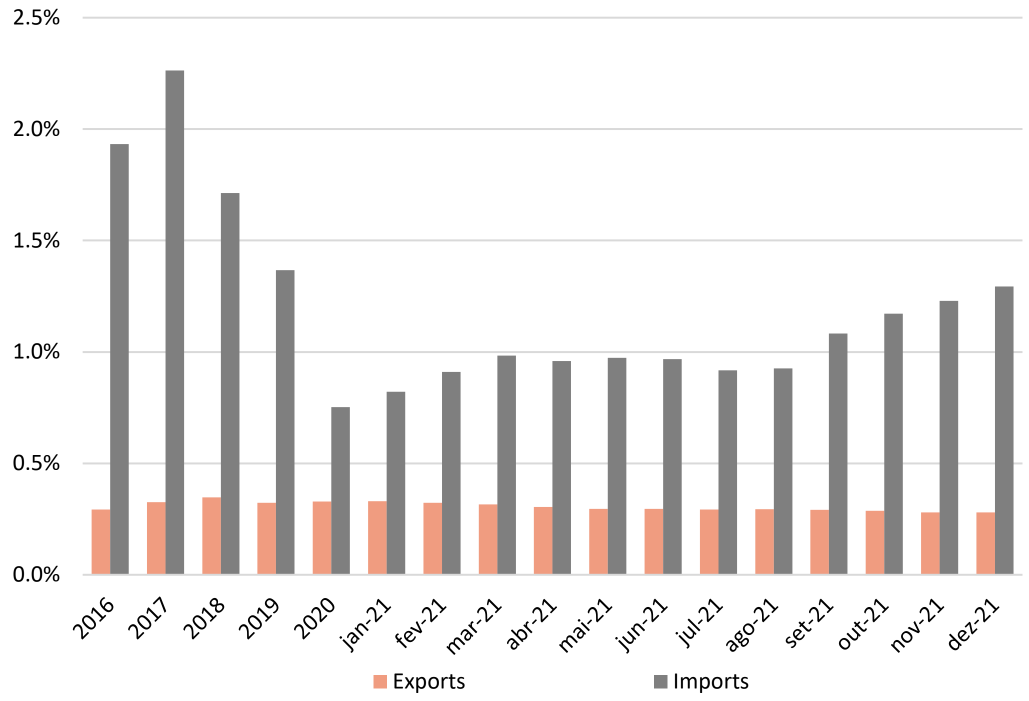
- **'Apoio à Produção' credit line for manufacturing and transport industries**: covering 70% of the credit, within a period of up to 8 years; 12-month grace period for capital. Requirements: weight >= 20% of energy costs in production costs; Increase in the cost of goods sold and consumed >= 20%; Drop in operational invoicing >= 15% due to reduction in orders related to scarcity or difficulty in obtaining raw materials, components or intermediate goods. €400 mln.

Others

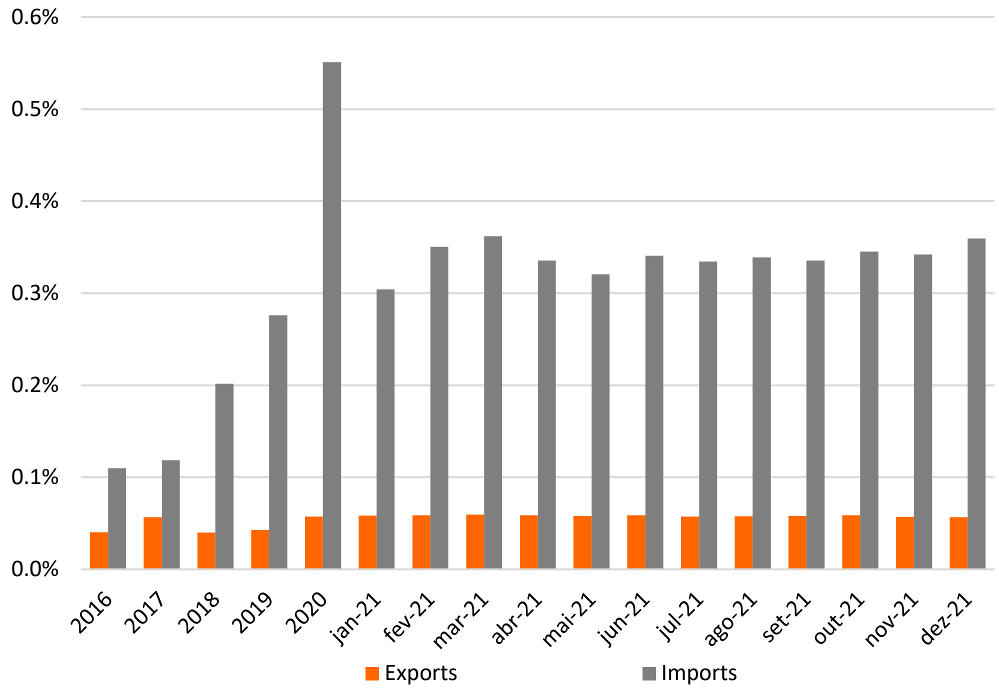
- Support for refugees: €50 mln
- Support for installation of photovoltaic panels in agro-industry, farms and hydro-agricultural developments: €46 mln
- Simplification of procedures related to the decarbonization of the solar panel industry in agro-industry, agricultural exploitation and hydro-agricultural developments and reinforcement of support funds: €97 mln.
- Reduction to the minimum rate of VAT on all electrical equipment that allows families to be less dependent on gas.

Reduced direct exposure to Russia and Ukraine

Trade balance with Russia
Weight in total exports and imports (accumulated 12 months)



Trade balance with Ukraine
Weight in total exports and imports (accumulated 12 months)

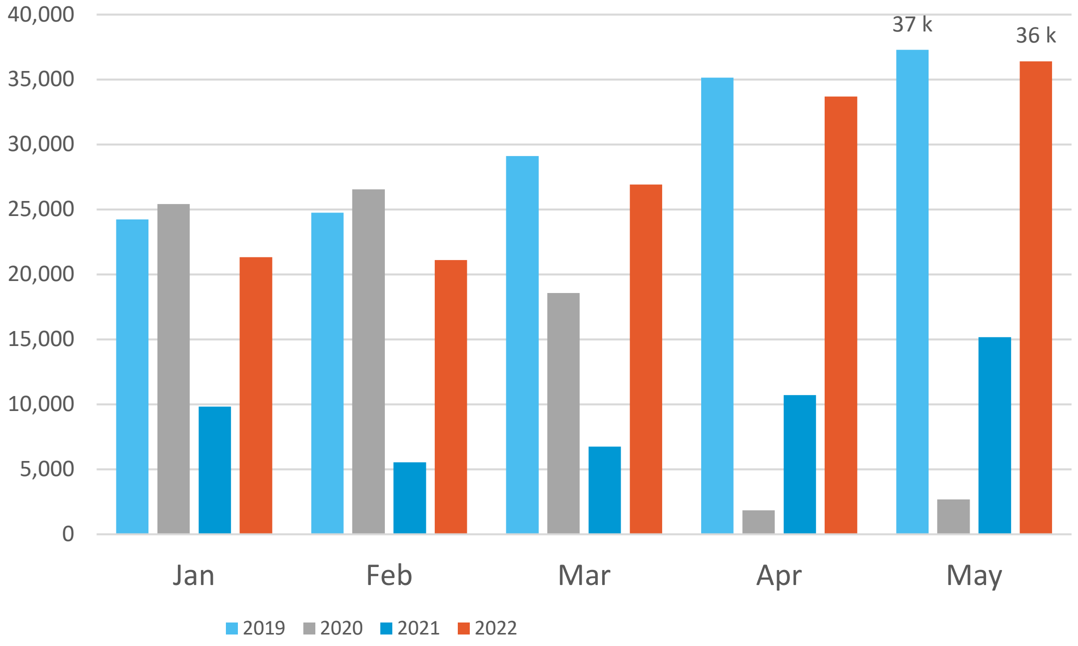


- Portugal's direct exposure to Russia (0.3% of exports) or Ukraine (<0.1%) is of little relevance**, so the expected effects on the Portuguese economy will essentially be indirect.**
- **The most obvious indirect effect will be through the increase in energy costs:** we estimate that an increase of 10$ per oil barrel and a 20€/MWh increase in gas prices reduces GDP growth by ~0.8 p.p..

Tourism is recovering as Covid related restrictions are removed

Number of flights, by month

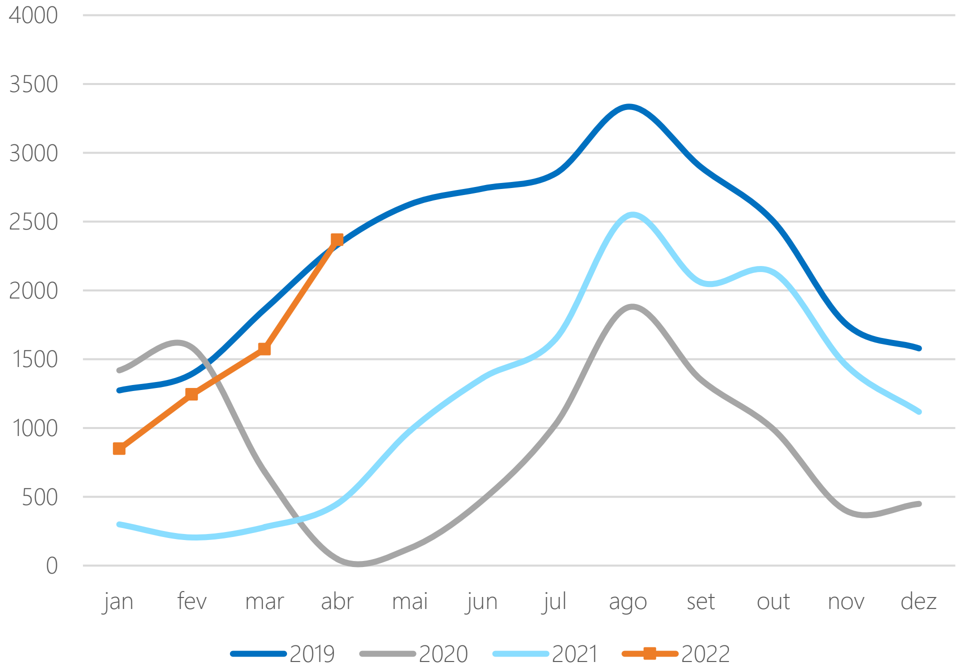
Number



Source: *BPI Research, based on EUROCONTROL data.*

Number of guests (foreign and national)

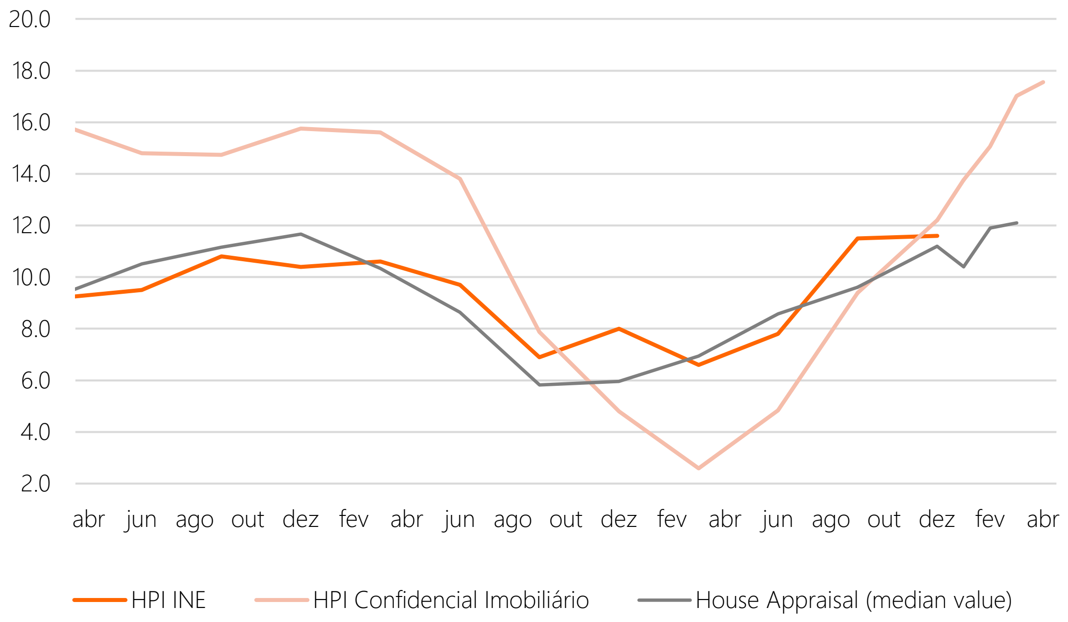
Thousand



- **Tourism has been the sector hardest hit by the pandemic:** in 2021, the number of tourists reached 14.5 million, 39% more than in 2020, but still 46% below 2019. In the last months, the number of international tourists visiting Portugal has been increasing at a strong pace, reducing the gap between Jan-Apr 2022 and Jan-Apr 2019 to 12%. Domestic tourism (40% of total tourism demand in pre-covid era) reached pre-pandemic levels and non-residents remain 21% below the accumulated level of 2019.
- **Fundamentals remain strong and are complemented by the well succeeded vaccination process.** The Portuguese tourism industry is the 12th most competitive in the world and "safety & security" is viewed as one of its biggest assets. Hence, recovery should be supported by the successful vaccination process with circa 90% of the population already fully vaccinated and the effectiveness of vaccines to minimize the pressure on health sector. However, **the revival is subject to uncertainty** as confidence is one of the main constraints and also some headwinds can arise associated with a slower than expected recovery of the European airline business and the recent war in Ukraine.

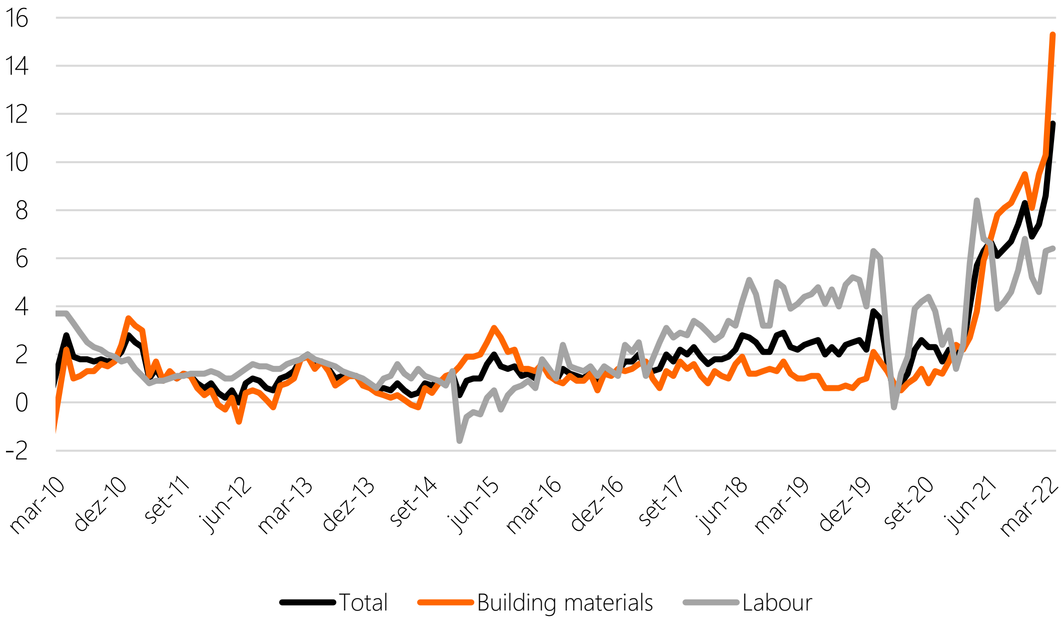
The real estate sector: resilience and solid fundamentals

Housing prices
Year on year (%)



***Source**: BPI Research, based on INE and Confidencial Imobiliário data.*

Construction costs index for new homes
yoy % change



***Source**: BPI Research, based on INE data.*

- Housing prices continue to accelerate and going forward, **the market should continue resilient as there are no signals of oversupply. On the other hand, prices are expected to moderate in the future**, in line with the end of *Vistos* Gold in main cities as well as some cooling down expected from domestic buyers due to the end of some Covid-related supporting measures (namely moratoriums) and also due to the upward trend in interest rates. Housing prices increased 9.4% in 2021 **and should decelerate to around 7.5% in 2022**.

The Government Budget Plan 2022: focused on consolidation

Government's draft budgetary plan 2022

Key elements	% GDP 2019	% GDP 2021	% GDP 2022	2019-2022 change (EUR millions)	2019-2022 growth rate (%)
Total revenue	**42.6**	**45.3**	**44.7**	**10,224**	**11**
Indirect taxes (VAT,...)	15.0	15.3	15.2	2,369	7
Taxes on income and wealth	9.7	9.7	9.6	941	5
Social contributions	11.8	12.8	12.5	3,040	12
Total spending	**42.5**	**48.1**	**46.6**	**14,874**	**16**
Worker salaries	10.8	11.8	11.4	2,635	11
Social transfers	18.1	19.6	18.9	4,178	11
Interest payments	3.0	2.4	2.2	-1,324	-21
Balance	**0.1**	**-2.8**	**-1.9**	**-4,650**	

***Source**: BPI Research, based on Bank of Portugal; forecasts by CaixaBank Research.*

Government reinforces the commitment to consolidate public accounts; after the positive surprise recorded in 2021 (with the public deficit declining to 2.8% vs. 4.3% expected and the 5.8% recorded in 2021), the Government is expecting a 1.9% of GDP deficit in 2022.

Revenue

- Government expects to reach 44.7% of GDP in 2022, more 2.1 p.p. than in 2019.
- Social contributions are forecasted to reach 12.5% of GDP (11.8% in 2019), reflecting goods prospects for labor market.
- Excluding revenues related with NG EU funds, revenues weights 43,4% on GDP.

Spending

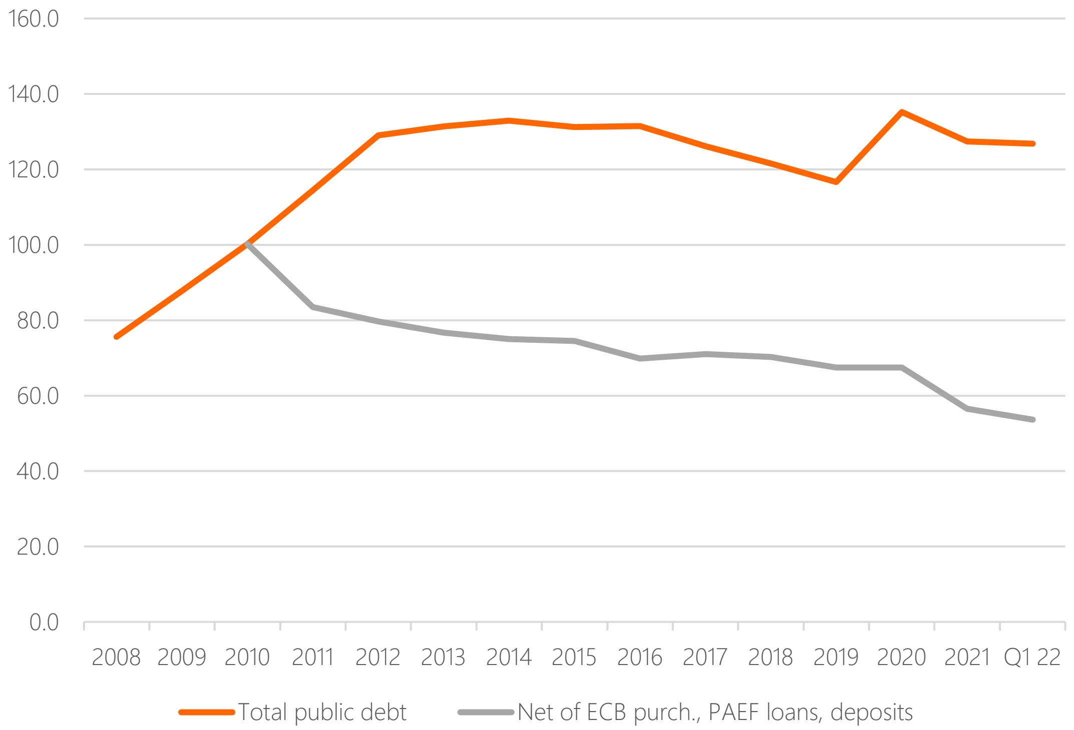
- Increase expected due to social benefits (which includes an extraordinary update of pensions), personnel expenses (update of public administration salaries by 0.9%) and public investment (with the implementation of the PRR). Expenditure exceeds 2019 levels by 4.2 p.p., but also includes the impact of the pandemic (albeit to a lesser extent) and measures to mitigate the impacts of the war, namely price and cost pressures for households and companies.

Budgetary policy bias

- Restrictive according to the Government (structural balance corrects from -1.4% of GDP in 2021 to -1.2% in 2022).

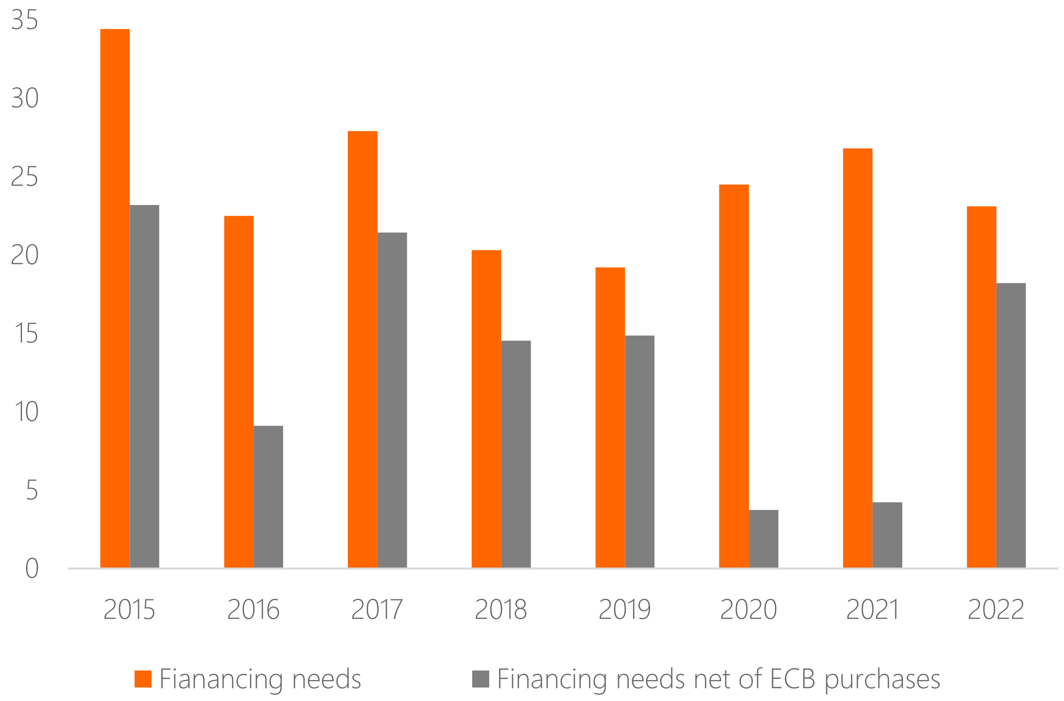
Prudent fiscal stance, the liquidity cushion and ECB reinvestments provide comfort in an uncertain environment

Public debt
(% GDP)



***Source**: BPI Research, based on Bank of Portugal; forecasts by CaixaBank Research.*

Portugal: Funding needs
(Billion euros)



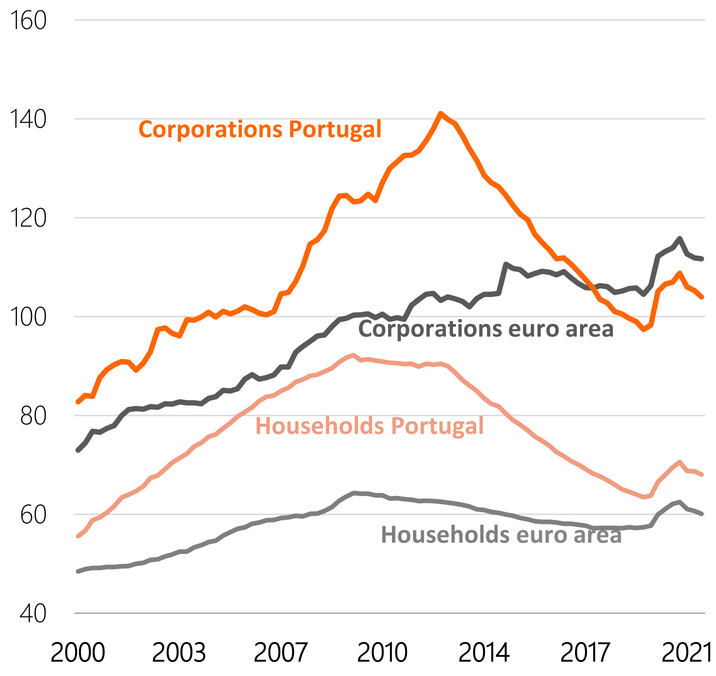
***Note (*)**: Budget execution according to cash basis.*
***Source**: BPI Research based on DGO.*

- **Public debt (% of GDP) decreased by 7.7 p.p. to 127.4% in 2021 and to 126.8% in Q1,** and is forecasted to decline to 119.5% of GDP in 2022, reflecting the expected narrowing of the fiscal balance and strong nominal GDP growth. We expect fiscal deficit to reduce to 1.7% of GDP in 2022, from 2.8% in 2021, in line with the Government forecast of 1.9% of GDP.
- **Financing needs for 2022 amount to 23 bn€, minus 4 bn€ than in 2021.** Assuming the end of the APP program in July (PEPP ended in March), ECB's net acquisition of Portuguese debt may decline to around 5 bn€, circa 20% of financing needs in 2022, pushing net financing needs not covered by the ECB to pre pandemic levels. Still, the current liquidity cushion amounts to around 19 bn€ (c. 9% of GDP) and the Treasury is forecasting its maintenance up to the end of 2022.

Private sector credit: deleveraging trend returns

Gross private debt

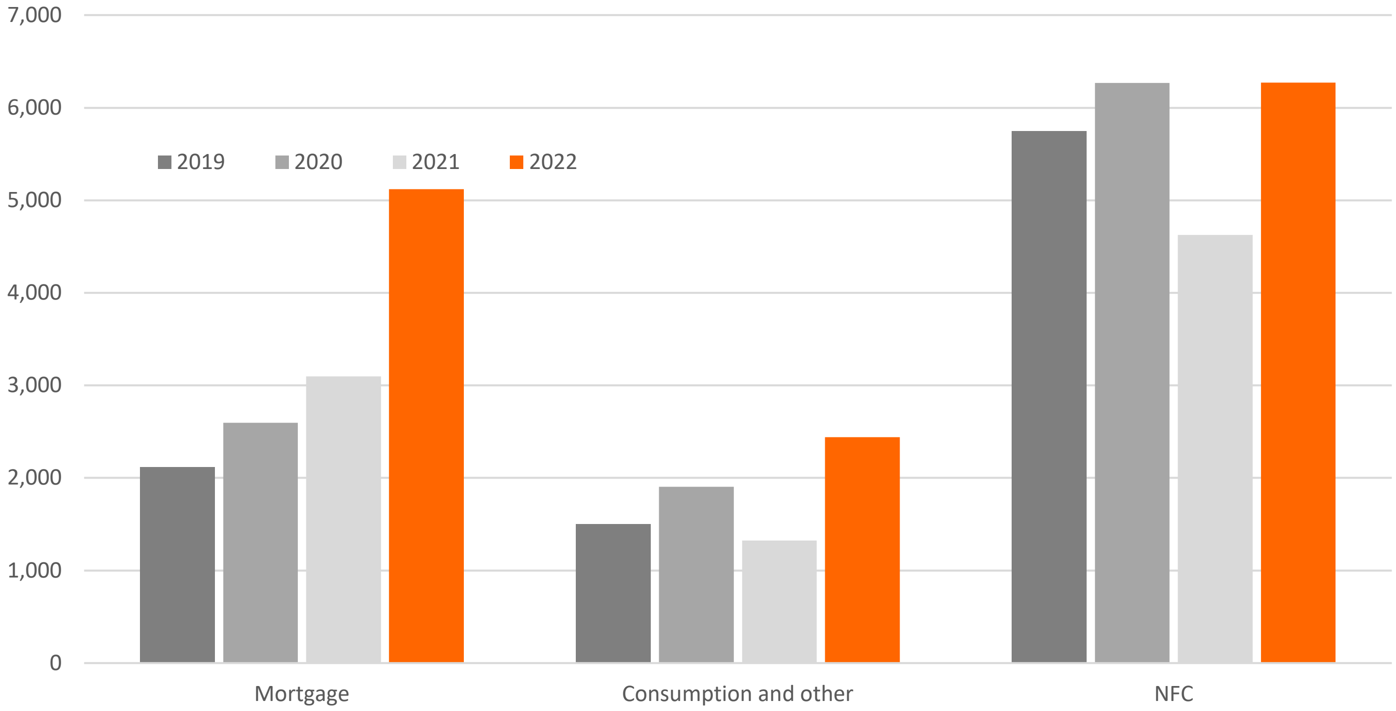
% of GDP, non consolidated debt.



Source: *BPI Research, based on Eurostat data.*

New lending activity in April by segments

(Million euros)



Note: *excluding renegotiations.*
Source: *BPI Research, based on BoP data.*

- **The end of moratorium justifies the return of the deleveraging trend in the private sector.** Corporate debt levels remain below euro area average despite the recent pick-up in credit outstanding (mostly due to state guaranteed credit lines). Household debt shows more gradual reduction, reflecting expanding mortgage lending.
- **In 2021, new lending for the non-financial private sector contracted 11.4% yoy**, reflecting the fall of new credit to NFC (-33.5%). However, when excluding Covid-related credit lines, credit to companies decreased less (-9.9% yoy). New operations for **households showed a strong performance, especially on mortgage operations** (increasing housing prices, financing conditions, employment-supporting measures).
- **Up to April 2022, new operations showed a positive trend**: new credit for NFC and households increased 5.3% and 24.3%, respectively. The dynamics was especially positive in March and April, specially for NFC; mortgage credit continues strong even if it is decelerating. However, the interest rate on new mortgage credit have started to increase, reflecting the market expectations for the monetary policy normalization. This increase, as well as the setback in confidence after the Ukraine war, could cool down the new mortgage credit.

The Portuguese banking system: resilient and supporting the economy

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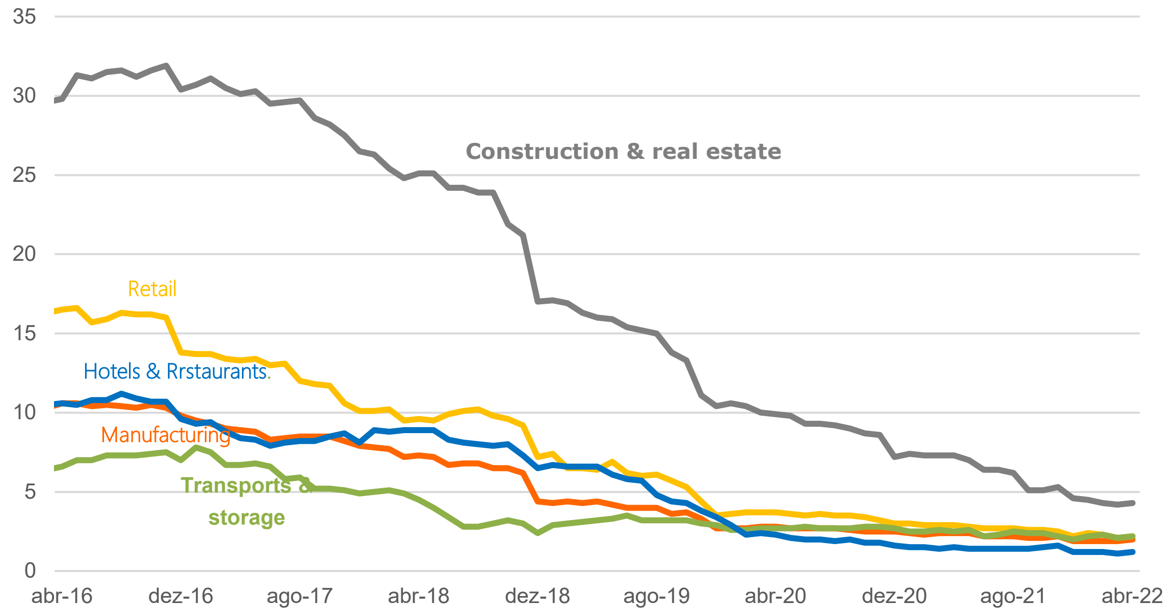
Non financial private sector: Overdue loans

(%)



***Source**: BPI Research, based on BoP data.*

Private domestic credit

Year on year (%)

	Apr 2021 % yoy	Apr-2022 % yoy	2022 (For.) % yoy
Credit to the non-financial private sector	**5.4%**	**2.7%**	**-0.9%**
Households	**2.3%**	**3.7%**	**0.7%**
Housing mortgages	**3.0%**	**3.0%**	**1.3%**
Other purposes	**0.0%**	**6.4%**	**-1.7%**
Consumer lending	**-0.1%**	**6.1%**	**0.9%**
Non-financial corporations	**11.0%**	**1.0%**	**-3.6%**

***Source**: BPI Research, based on BoP data.*

- **Moratorium was an important supporting measure for both households and firms in the COVID context.** Specifically in the case of companies, **credit under moratorium reached a maximum of 34.1% of total NFC credit between August and October 2020. Moratorium ended at the end of 2021** for those who applied until March 2021.
- Considering the importance of this measure and the potentially negative impacts on the firms' solvency after its end, the Government decided to give a public guarantee (maximum of 25% of credit) directed towards the most affected sectors (with revenue drop of at least 15% in 2020 in comparison to 2019; firms that did not achieve the 2019 revenues level yet) and those who previously renegotiate with banks their credits (extending the grace period – without capital reimbursements - and enlarging the maturity). **Given the ample cushions in the banking system and the healthy balance sheet of households and companies compared with past situations, we don't expect a significant deterioration in NPL's due to the end of moratoria**.

Main economic forecasts

%, yoy	2014	2015	2016	2017	2018	2019	2020	2021	Forecasts 2022	Forecasts 2023
GDP	0.8	1.8	2.0	3.5	2.8	2.7	-8.4	4.9	6.6	2.0
Private Consumption	2.4	2.0	2.6	2.1	2.6	3.3	-7.1	4.5	5.9	2.4
Public Consumption	-0.6	0.8	0.8	0.2	0.6	2.1	0.4	4.1	1.7	0.2
Gross Fixed Capital Formation (GFCF)	2.3	5.9	2.5	11.5	6.2	5.4	-2.7	6.4	5.1	6.7
Exports	4.3	6.3	4.4	8.4	4.1	4.1	-18.6	13.1	12.8	5.0
Imports	7.9	8.0	5.0	8.1	5.0	4.9	-12.1	12.9	8.4	6.9
Unemployment rate	14.5	13.0	11.4	9.2	7.2	6.6	7.0	6.6	5.9	5.7
CPI (average)	-0.3	0.5	0.6	1.4	1.0	0.3	0.0	1.3	6.0	2.2
External current account balance (% GDP)	0.2	0.2	1.2	1.3	0.6	0.4	-1.2	-1.1	-2.2	-1.1
General Government Balance (% GDP)	-7.4	-4.4	-1.9	-3.0	-0.3	0.1	-5.8	-2.8	-1.7	-0.7
General government debt (% GDP)	132.9	131.2	131.5	126.1	121.5	116.6	135.2	127.4	119.5	116.6
Risk premium (PT-Bund) (average)	252	189	307	269	138	98	89	60	100	107

Source: *BPI Research.*

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