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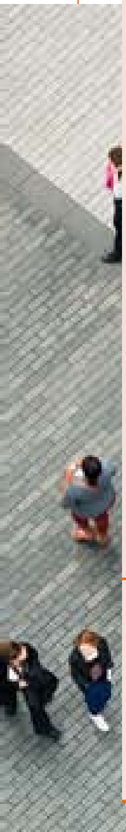
Portugal:
Macroeconomic and financial outlook

BPI *Research*

October 2022

BPI Grupo CaixaBank

Main messages



Activity

- **Growth forecasts for 2022-23 were downward revised to 6,3% and 0,5% due to the impact of the energy crisis in Europe and significant headwinds coming from higher interest rates.** This scenario does not consider the need of gas rationing in northern and central Europe and is subject to a high degree of uncertainty. Risks are biased to the negative side and are related to the possible occurrence of a colder winter than usual, problems in the supply flow of gas in Europe or the eventual need of gas rationing. Portugal is more safeguarded than central and northern Europe as the proportion of renewables in the primary energy mix is higher, dependence on Russian gas is low (2021: total energy imports from Russia represented 8% of total energy imports), and also due to the capacity to receive LNG (port of Sines) and due to the existence of long term contracts with different gas providers.
- **inflation accelerated in September to 9,3%,** and is expected to remain high due to the pressure in energy prices and contagion to other goods. We revised upwards our forecast **to 7,9% in 2022 and 5,7% in 2023.**
- **High frequency indicators related to the tourism sector confirm the strong summer season.** In August the number of tourists surpassed again the same pre-pandemic month, and according to World Travel & Tourism Council the number of flights booked for the Summer months put Portugal in the 4th most popular destination in Europe.
- **Housing prices accelerated further in Q2 (3,1% qoq and 13,2% yoy), consolidating expectations of an annual rise above 10%.** But a considerable slowdown is expected in 2023, to around 1,0%, reflecting the impact of higher interest rates. The likelihood of a severe correction in prices is quite low as prices remain in line with fundamentals and supply progresses smoothly.
- **Net asset purchases** under APP ended on July 1st and key rates increased by 50bp in July and 75 bp in September. Still in July, the ECB announced a new anti-fragmentation tool that we expect will continue to help contain the risk premia of peripheral countries. **By the end of July**, ECB purchases this year covered 25% of the Government's financing needs; going forward the support will remain through reinvestments and the anti-fragmention tool.
- **Government released the State Budget for 2023, confirming that the main focus continues to be fiscal consolidation.** Pubic deficit is expected to decline to 0,9% of GDP from 1,9% in 2022; and the public debt ratio will decline to 110,5% of GDP from 115% in 2022. For 2022, the fiscal deficit is expected to decline to 1,7% of GDP (2,8% in 2022). And the public debt ratio to 119,5% of GDP from 127,4% in 2021, Still, according to IMF in a scenario of unchanged policies, public debt is seen to fell below 100% in the medium term. At last, the Treasury liquidity cushion amounts to circa €25 bln (≈11% of GDP), close to historical maximums (2018:€27 bln),
- **In September, the Government adopted a set of measures to reduce the impact of inflation on households income, 2,4 bln euros (~1% of GDP)that will be implemented until year end, some of them in the form of direct and one-off transfers to households. Additionally, the SB 23 includes a package of 1,3% of GDP to mitigate loss of income by families and higher costs by enterprises related to higher energy prices and higher financing costs.**

Banking Sector

- **Credit quality indicators improved further in Q2 2022 and risks related with higher interest rates are contained,** as macroprudential measures are relatively tight. Recently, additional measures were taken in order to reduce the maturity of housing loans; additionally, before granting a loan, banks have also to communicate the impact on the debt service of an hypothetical increase of interest rates by 300 basis points on mortgages loans. Additionally, the strong position of the labour market, expected to worsen very moderately, and the improved position of households and firms in terms of leverage, also suggest that the interest rate impact on credit quality might be moderate, in a context of a strong position of the banking sector.

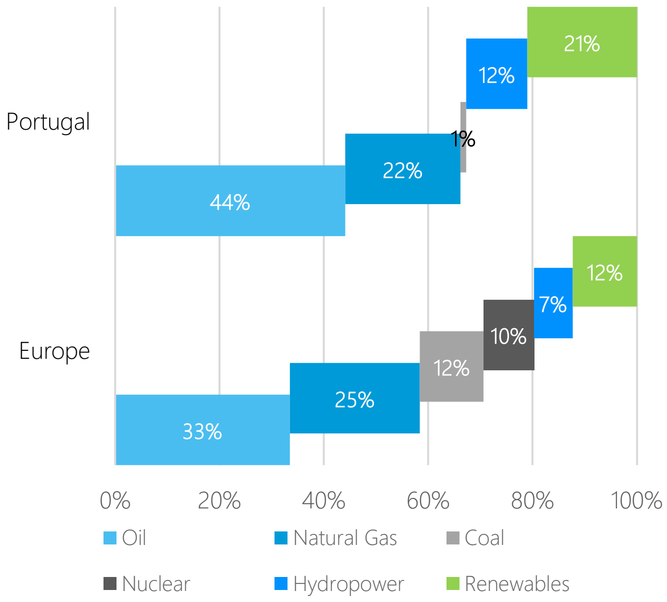
Main economic forecasts

%, 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	-8.3	5.5	6.3	0.5
Private Consumption	2.5	1.9	2.6	2.1	2.6	3.4	-6.9	4.7	5.0	0.5
Public Consumption	-0.5	0.8	0.8	0.2	0.6	2.1	0.4	4.6	2.0	-0.2
Gross Fixed Capital Formation (GFCF)	2.3	5.9	2.5	11.5	6.2	5.4	-2.2	8.7	1.7	3.8
Exports	4.3	6.2	4.4	8.4	4.1	4.1	-18.8	13.5	16.5	4.3
Imports	8.1	8.1	5.0	8.1	5.0	4.9	-11.8	13.3	10.1	5.0
Unemployment rate	14.5	13.0	11.4	9.2	7.2	6.6	7.0	6.6	5.9	6.4
CPI (average)	-0.3	0.5	0.6	1.4	1.0	0.3	0.0	1.3	7.9	5.7
External current account balance (% GDP)	0.2	0.2	1.2	1.3	0.6	0.4	-1.2	-1.1	-2.7	-2.3
General Government Balance (% GDP)	-7.4	-4.4	-1.9	-3.0	-0.3	0.1	-5.8	-2.8	-1.9	-1.4
General government debt (% GDP)	132.9	131.2	131.5	126.1	121.5	116.6	135.2	127.4	119.5	117.0
Risk premium (PT-Bund) (average)	252	189	307	269	138	67	59	65	130	115

***Source**: BPI Research.*

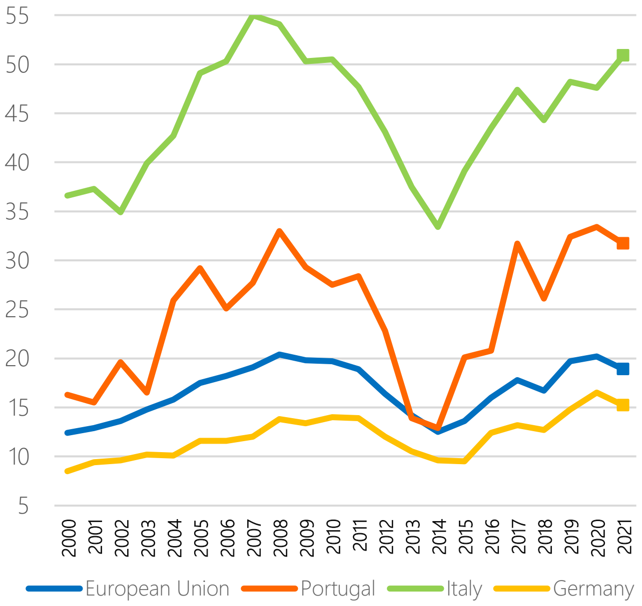
Energy mix with more Renewables provides a buffer against volatile environment

Primary energy source
%



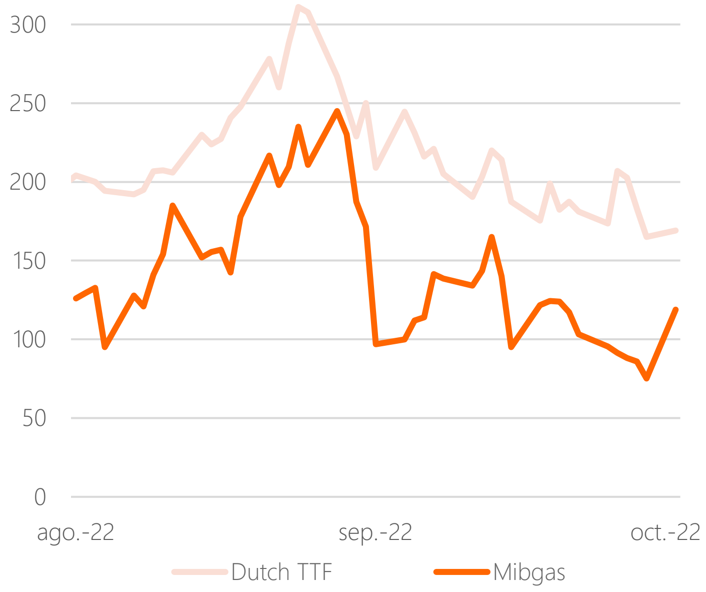
Source: BPI Research, using data from Our World in Data.

Share of electricity generated by gas
%



Source: BPI Research, using data from Our World in Data.

Natural gas price: Dutch TTF *versus* Mibgas
Eur/MWh



Source: BPI Research, using data from Bloomberg.

- **Compared to the rest of Europe, Portugal is more dependent on oil as a primary energy source (44%).** On the other hand, the energy component via renewable energies is also substantially higher**.**
- **In 2021, natural gas was the source of 31,7% of the electricity produced**, meaning that the country is also exposed to the price of gas, which has experienced a sharp increase on international markets in the context of geopolitical tension with Russia and war with Ukraine (in March 2021 Dutch TTF, the European benchmark for gas, was trading gas at ≈ 17 eur/MWh and in the end of August 2022 the price peaked to 311 eur/MWh. It is now trading at around 160 eur/MWh).
- Despite what is stated in the previous point, **the reference gas price in the European market (Dutch TTF) has been significantly higher than the reference price in the Iberian gas market (Mibgas).** The difference is justified by the fact that the closure of gas pipelines in Russia has turned the European gas market into a market with a preponderance of LNG (liquefied natural gas). Unlike the Iberian Peninsula, which has ample capacity to receive LNG, the rest of Europe does not have sufficient infrastructure to receive and gasify the gas it needs. The lack of adequate gas and electricity interconnection between the Iberian Peninsula and France causes this gap to persist.

GDP: strong growth in 2022, but there are clouds over 2023

Main macroeconomic scenario

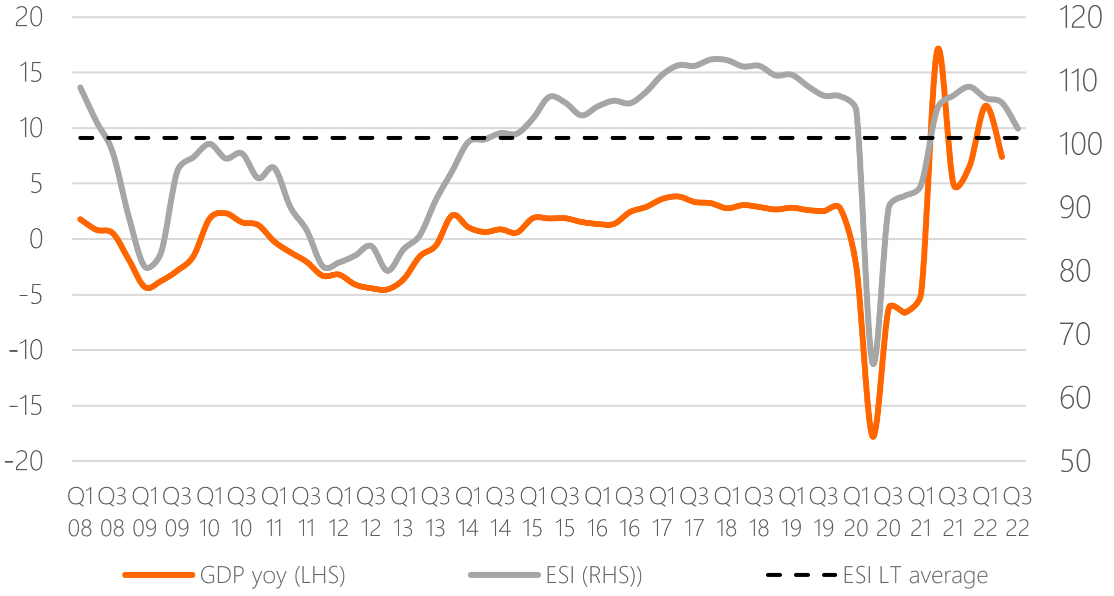
%

	2021	2022	2023	2024
Real GDP	5,5	**6,3**	**0,5**	**2,0**
Headline inflation	1,3	**7,9**	**5,7**	**2,2**
Core inflation	0,8	**5,5**	**4,4**	**2,3**
Unemployment rate	6,6	**5,9**	**6,4**	**6,1**

Source: BPI Research, *from INE.*

GDP & EC Sentiment indicator

Yoy, level



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

- Growth was revised upwards in 2021 from 4,9% to 5,5% and also in Q2 2022, to a quarterly growth of 0,1% from 0,0% and to 7,4% yoy from 7,1%. Despite the strong path, we revised downward our forecast for growth in 2022, reflecting signs of deceleration in Q3 and the risk of a contraction in Q4. As our revision preceded INE's revisions, risks for growth in 2022 are biased on the upside.
- For 2023, we expect a strong deceleration of activity, reflecting the impact of the energy crisis in Europe and strong headwinds coming from higher interest rates; inflation is expected to remain high due to persistently high energy prices and contagion to other goods; unemployment should rise a bit reflecting the strong deceleration of activity. Hence, despite the tailwinds due to the still comfortable position of households in terms of excess savings and also derived from the stimuli coming from the execution of NGEU, we consider that the increase in interest rates, the persistence of high inflation and the negative impact of the energy crises on external demand will prevail, causing significant deceleration of economic activity.
- The scenario is subject to a high degree of uncertainty that, for now, seems to be biased on the negative side. Indeed, if the winter is colder than usual, if energy saving measures are not efficient or if there is any disruption on the gas alternative suppliers and flows in Europe, a scenario of energy rationing in Northern Europe might be needed, with negative consequences for economic growth. Additionally, but still a risk is the possibility of new virus waves, with negative consequences for growth.

The pace of expansion will slow towards the end of the year

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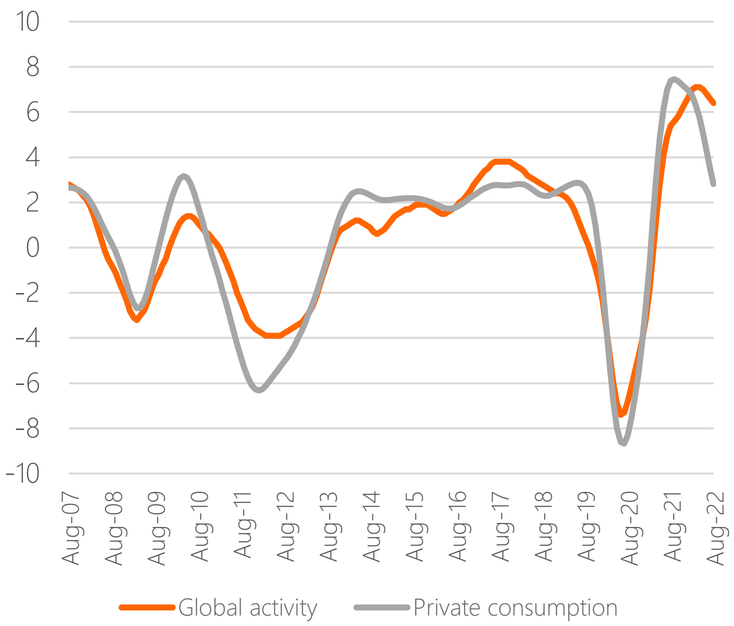
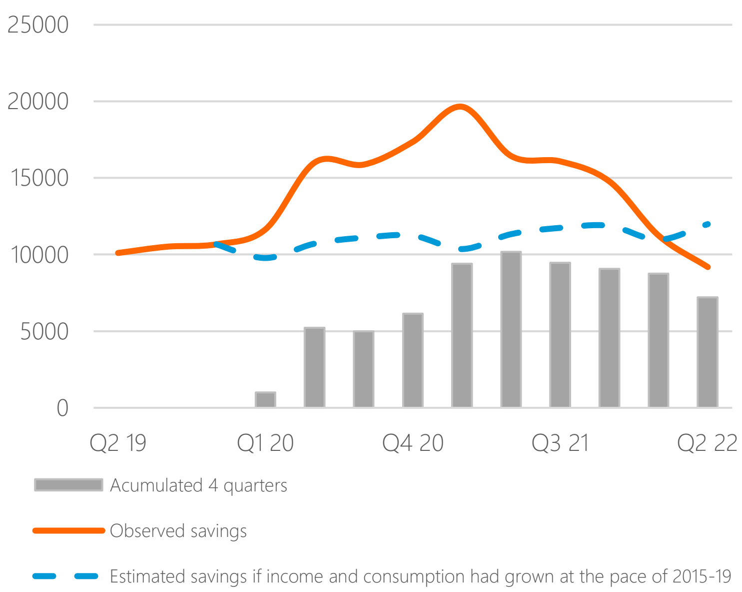
Coincident indicators
%



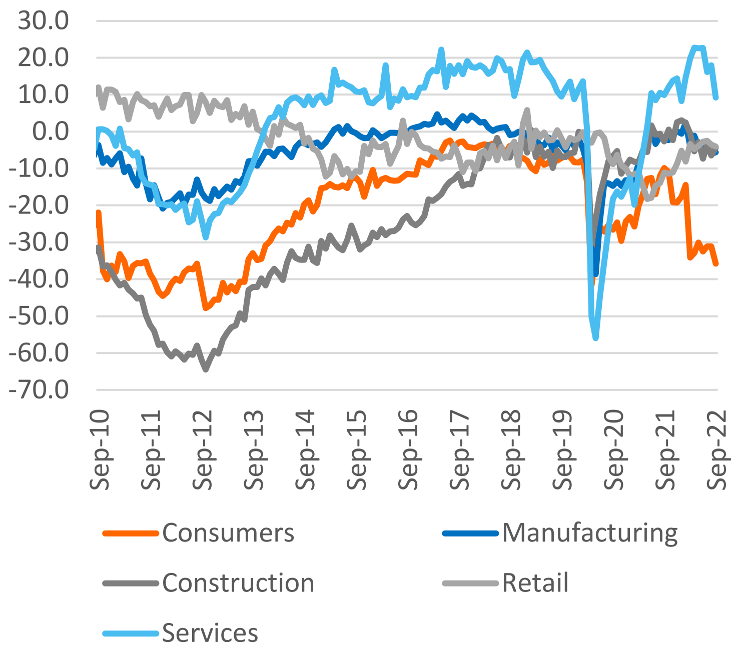
Source: BPI Research, from BdP,

Savings and extra savings
Million of €



Source: BPI Research, using data from INE.

Confidence indicators
Level



- **Composite indicators are showing a deceleration in the H2 2022**. Nevertheless, data related with tourism continues strong and showing some support to growth.
- **Families started to spend their accumulated savings during the pandemic, but it still amounts to €7,2 million** (3% of GDP) which will help to accommodate the environment of higher inflation and higher interest rates in the coming quarters. Main risk is related to the possibility that these savings are concentrated in top-income households with lower propensity to consume. Even if that is the case, this should provide at least a buffer to the evolution of private consumption going forward.
- **Sentiment indicators**: Consumers confidence fell to levels close to ones seen in the sovereign debt crisis suggesting more precautionary behavior ahead, in line with our scenario; sentiment in services, industry, construction and retail is deteriorating too.

Labor market remains robust but there are signs of less appetite for hiring

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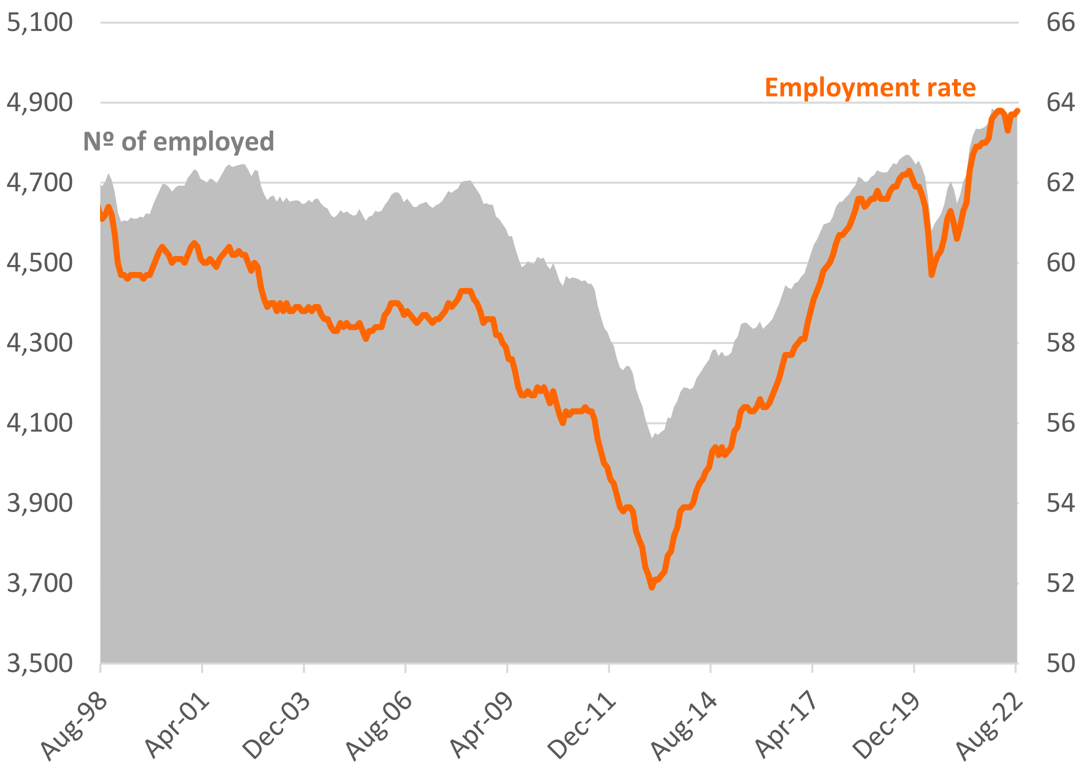
People employed and employment rate

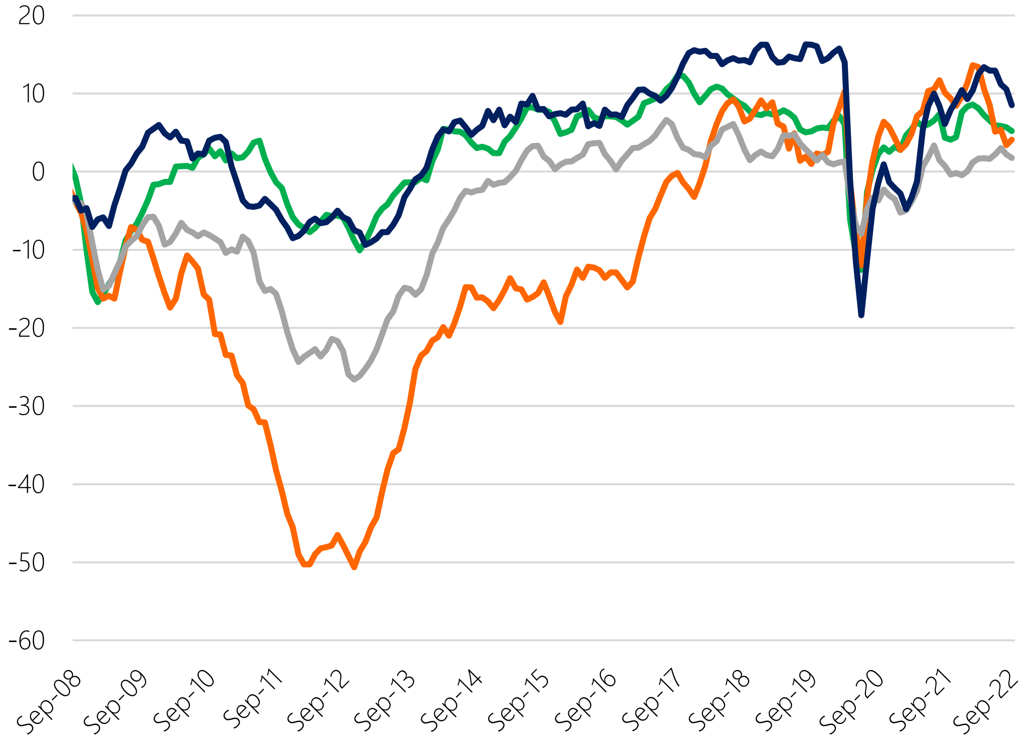
Thousand people/% of work age population (15-64)



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

Employment perspectives for the next 3 months

Level



- **Employment is at maximum levels** and labour market data suggest that it will continue strong, This is an important factor supporting consumption and economic growth,
- **Difficulties in hiring** is one of the obstacles pointed out by companies,

Inflation: global inflation surpasses 9% and the period of high inflation will be longer

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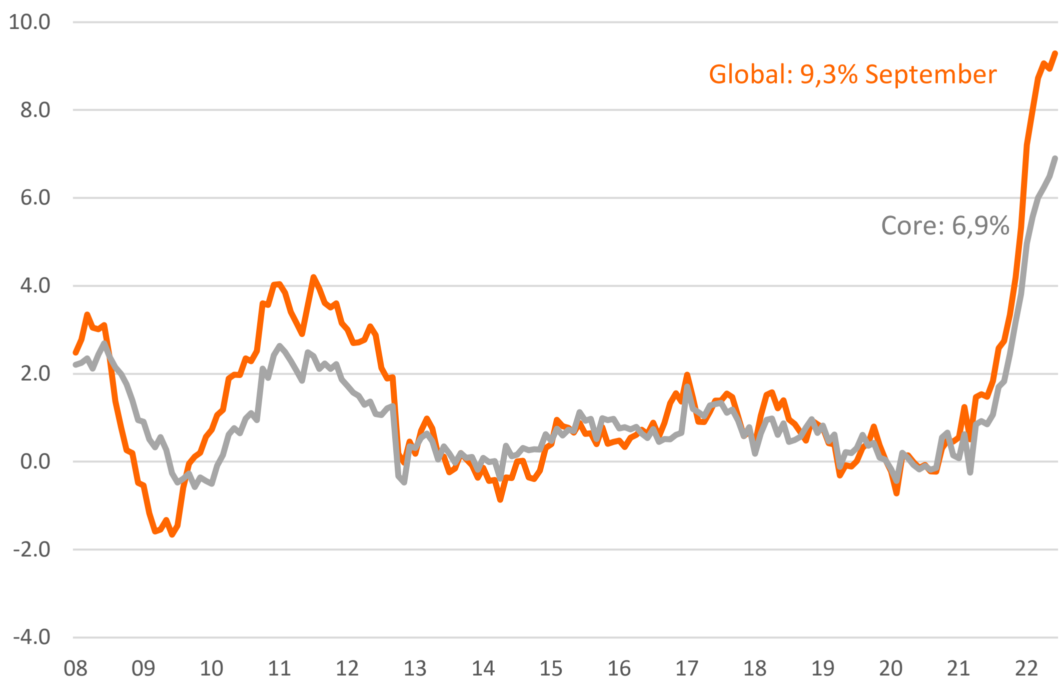
The global and core inflation

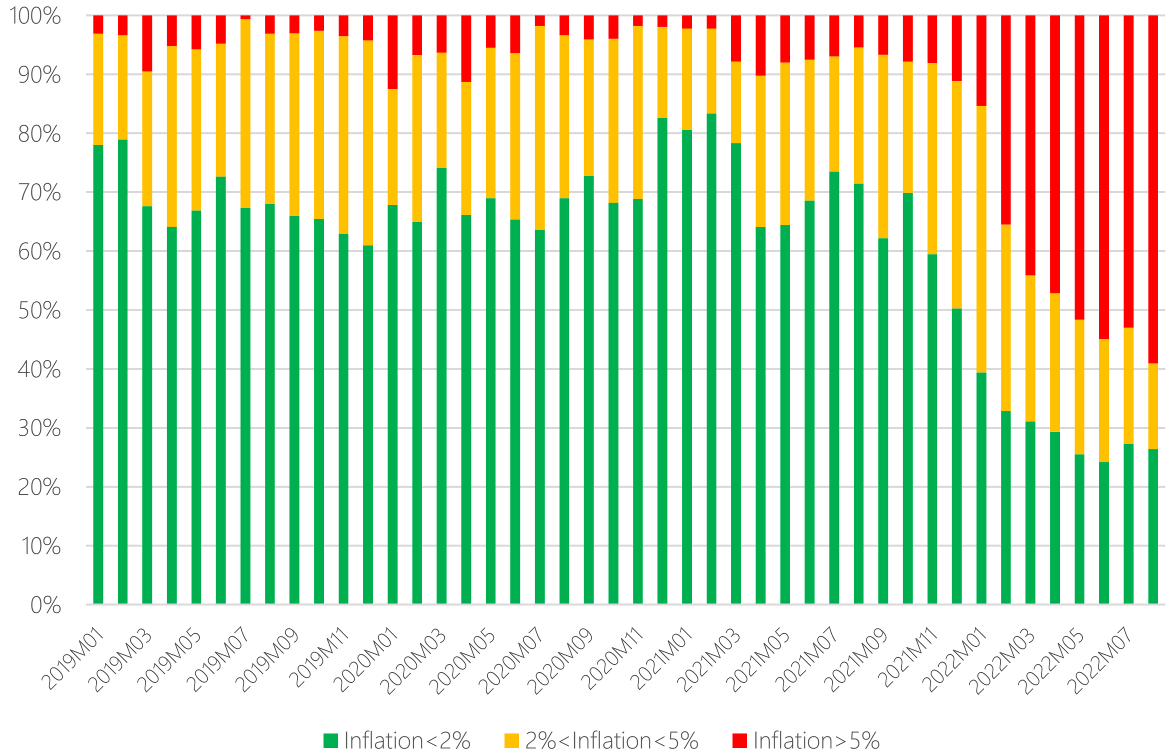
Year-on-year (%)



Source: *BPI Research, from INE.*

The inflation traffic light

% of CPI basket



- **Inflation accelerated** to 9,3% in September from 8,9% in August; energy prices decelerated in August, but high prices in these commodities continue to spread to other goods. Core inflation accelerated to 6,9%, from 6,5%.
- **We revised upwards inflation forecast for 2022 to 7,9% considering risks as balanced. Given the expectation that pressures will continue in some commodities' prices (energy and food) inflation is foreseen to remain higher during more time, For 2023 we are forecasting an annual average inflation of 5,7%.**

Strong tourism season as Covid related restrictions were removed

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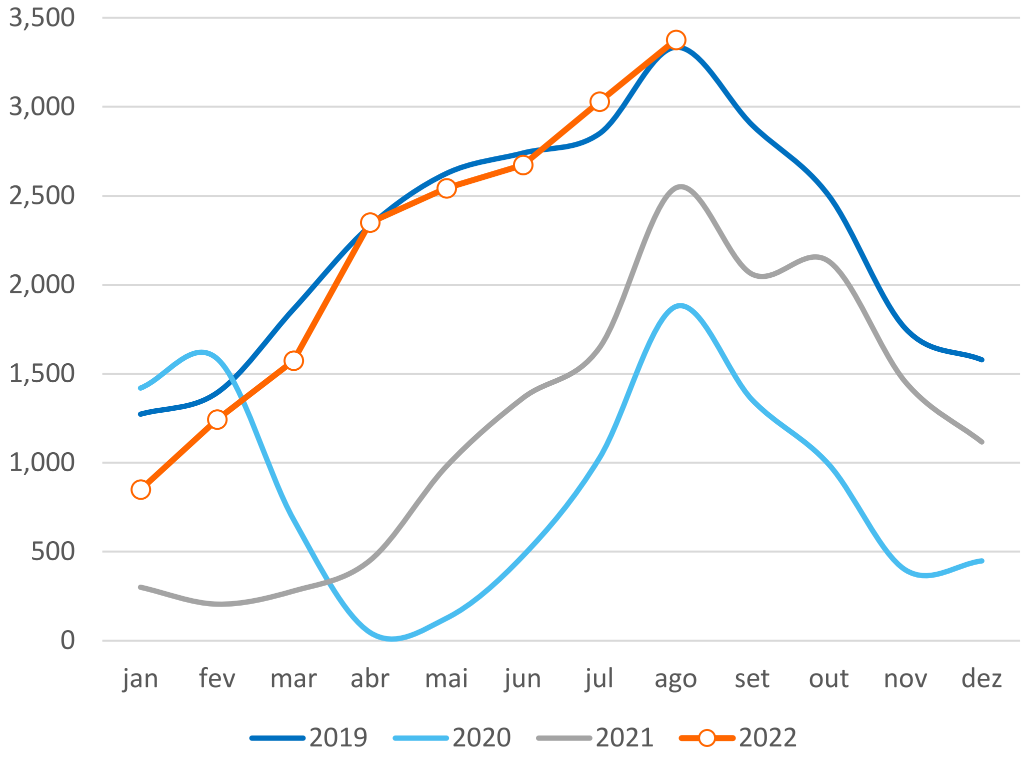
Number of guests (foreign and national)
Thousand



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

Number of guests (foreign and national)
versus same period of 2019 (%)

	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q 22
TOTAL	-83%	-64%	-31%	-19%	-19%	-2%
United Kingdom	-97%	-80%	-61%	-35%	-21%	2%
Germany	-93%	-84%	-57%	-17%	-26%	-4%
Spain	-93%	-71%	-37%	-17%	-30%	-3%
France	-91%	-83%	-31%	-28%	-15%	-11%
Brazil	-96%	-93%	-86%	-52%	-44%	-27%

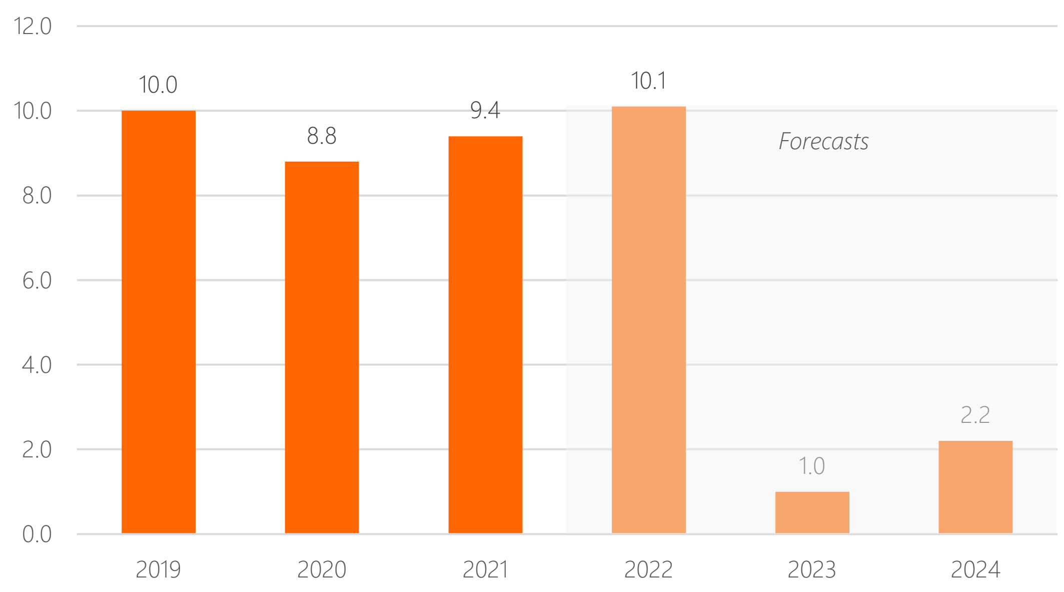
***Source**: BPI Research, based on INE data.*

- **Guests: in August the number of tourists surpassed again the same pre-pandemic month,** but the number of non-residents stood below August 2019 after having surpassed the 2019 level in July; resident tourists surpassed the numbers of 2019 (+4%), for the 5th month in a row.
- In the most recent booking surveys Portugal is identified as one of the most resilient destinations in 3Q 2022 (only -9% of international tourists than in 2019).
- **Despite this good behavior, full recovery to above pre-pandemic levels should occur only in 2023.**

The real estate sector: resilience and solid fundamentals

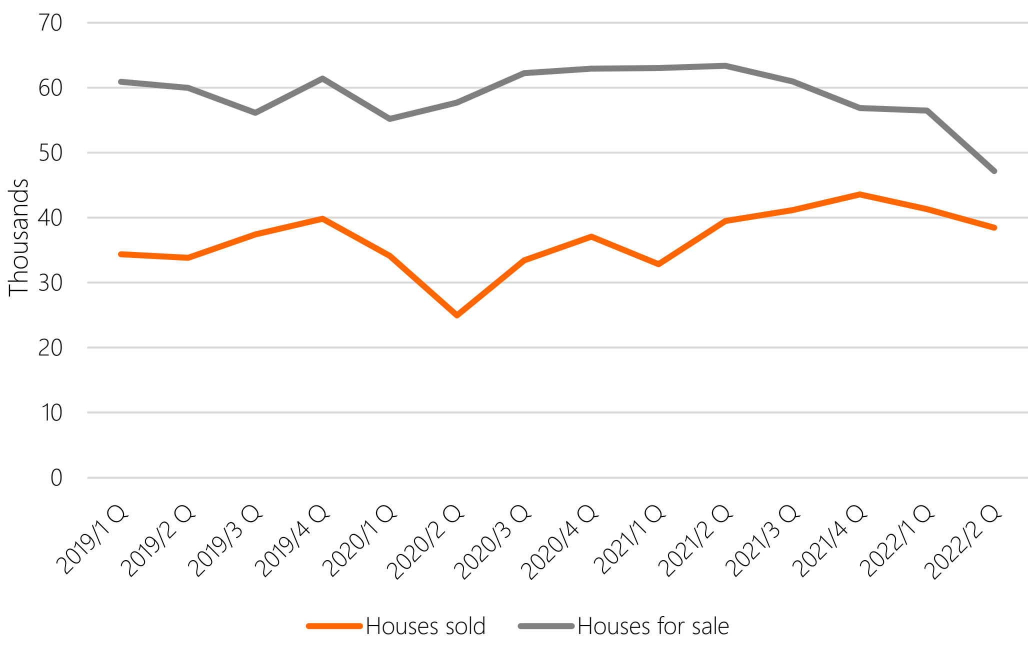
Housing prices

Annual change(%)



Source*: BPI Research, based on INE.*

Houses sold versus Houses for sale



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

- In Q2 22, housing prices rose 3,1% qoq and 13,2% yoy, confirming that prices will rise more than 10% in 2022. Going forward, market is expected to cooldown, as higher inflation and more restrictive financial conditions will impact family budgets and moderate the current levels of housing demand. But an harsher scenario should be avoid as the residential housing market continues supported by supply shortage, whereas demand keeps supported by residents, although more moderate than in the past, as well as by non-European buyers.

The state budget 2023: main figures confirming that fiscal consolidation is the focus

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The macroeconomic scenario

(%)

	2022	2023	
		SB 2023	BPI
GDP	**6,5**	**1,3**	**0,5**
Private consumption	5,4	0,7	0,5
Public consumption	1,8	2,3	-0,2
GFCF	2,9	3,6	3,8
Exports	18,1	3,7	4,3
Imports	12,0	4,0	5,0
HCPI*	7,4	4,0	5,7
Employment	1,9	0,4	-0,3
Unemployment rate	5,6	5,6	6,4
Current account, % of GDP	-1,3	-1,1	-2,3

Note (*): CPI for BPI forecasts

***Source**: CaixaBank Research, based on the SB 2023.*

State budget 2023

Year-to-date (% GDP, unless otherwise specified)

	2019	2020	2021	2022	2023	Var, 2023 vs 2019	Var,2023 vs 2022 (million euros)
Revenues	**42,6**	**43,4**	**44,9**	**44,1**	**44,6**	**2,0**	**6,218**
Tax Revenue	24,7	24,6	24,7	25,4	24,8	0,1	1,579
Social Security Contributions	11,8	12,8	12,7	12,3	12,3	0,5	1,504
Expenses	**42,5**	**49,2**	**47,8**	**46,0**	**45,5**	**3,0**	**3,994**
Personnel expenses	10,8	11,9	11,6	10,9	10,9	0,1	3,417
Current Transfers	18,1	20,0	19,4	19,0	18,1	0,0	-70
Acquisition of Goods and Services	5,1	5,5	5,8	5,7	6,0	0,8	1,387
Interests	3,0	2,9	2,4	2,1	2,5	-0,4	1,197
Investment	1,8	2,4	2,6	2,7	3,5	1,6	2,323
Budget Balance	**0,1**	**-5,8**	**-2,9**	**-1,9**	**-0,9**	**-1,0**	**2,224**
Primary Balance	**3,1**	**-2,9**	**-0,5**	**0,3**	**1,6**	**-1,4**	**3,421**

- **The Government macroeconomic scenario is slightly more optimistic than our own. However, these differences are not reflected in the bottom line figures for fiscal policy.** Indeed, we conclude that the Government is being too cautious on the evaluation of the public accounts in the current year (the deficit should be lower than the official forecast given the execution so far), while a bottom-up evaluation for goals in 2023 reveal also prudent assumptions.
- The public deficit in 2022 was kept unchanged in 1,9% of GDP, the same as targeted in the 2021 Budget. However**, there is a strong probability that the final figure reveals a smaller deficit. Indeed, until August, the Public Administration balance, on cash basis, reached a surplus of 1.5% of GDP.** For 2023, the Government sees the deficit narrowing to 0,9& of GDP. Revenues will continue to grow at a solid rate (in line with nominal GDP growth).
- Expenses with interests are expected to increase to 2,5% of GDP, the highest level since 2020, and in line with our estimate given the expected path for interest rates and considering the roll-out of maturing debt, with high absolute coupons still reaching maturity.

Measures in the state budget 2023 to mitigate loss of income and higher costs

Measures included in the package amount to €3,0bn euros (1,3% of GDP)

Measure	Who benefits (million people)	Cost of the measure (million €)	% of GDP
Families ***of which:***		**2,781**	**1,19**
• Update of the Social Support Index (IAS)	1,6	155	0,06
• Wage increases and other valorization in the Public Administration	0,742	1,320	0,53
• Across-the-board IRS reduction	>4,0	500	0,20
• Minimum Existence Reform	0,8	200	0,08
• Family Allowance Reinforcement	0,48	95	0,04
• Free daycare centres	0,06	60	0,02
• Compensation for capping the increase in rents to 2%	1	45	0,02
• Optional reduction of withholding taxes for home loan holders	1,4	250	0,10
• VAT cut on electricity	5	90	0,04
• Maintenence of th cost of public transportation	1,116	66	0,03
Enterprises ***of which:***		**235**	**0,12**
• Tax benefit to wage valuation	500 k companies	75	0,03
• 20% increase in corporate tax deduction for energy expenses and 40% increase in agricultural production expenses	>500 k companies	60	0,02
• Extra support for fuel costs in agriculture	145	40	0,02
• Extension of the reduced rate for SME	221 k companies	60	0,02

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

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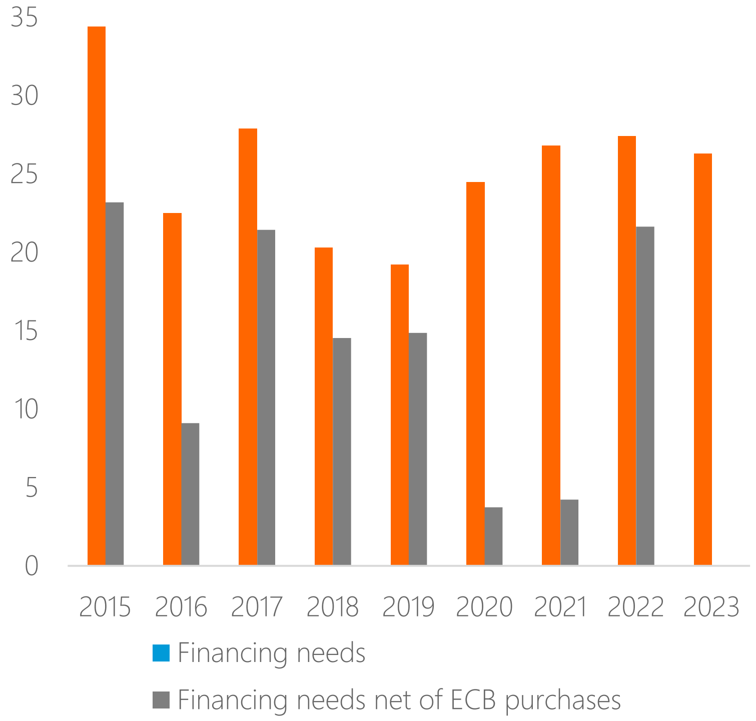
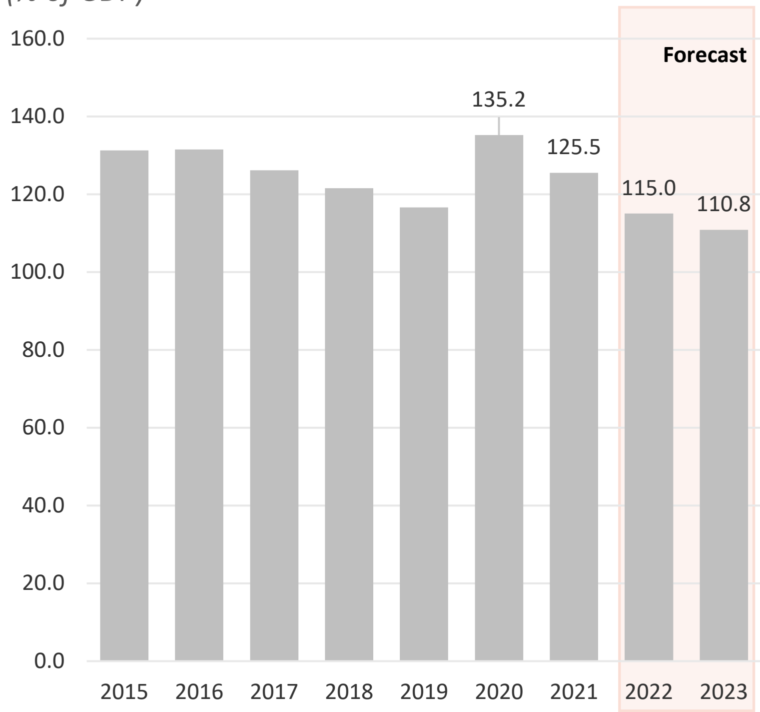
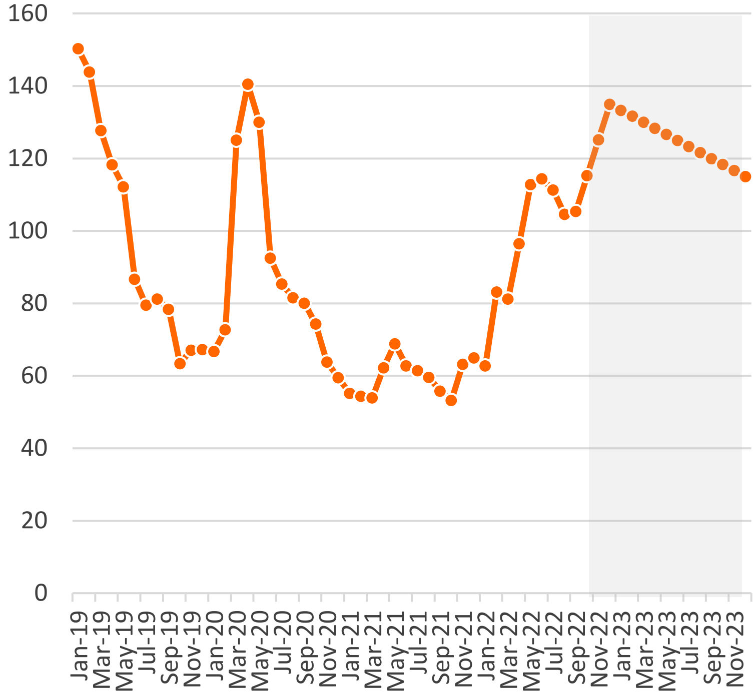
Funding needs
(Billion euros)



Public debt ratio
(% of GDP)



Sovereign risk premium
b.p.



***Source**: BPI Research, based on DGO and state budget 2023.*

- **Financing needs for 2022 amount to €27 bn and are expected to fall to €26 bn in 2023.** Up to the end of the APP and PEPP programs, ECB's net acquisition of Portuguese debt amounted to around €6 bn, circa 25% 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 €25 bn (c, 11% of GDP).
- The Portuguese treasury is carrying out a policy of repurchase of short-term securities and selling bonds with longer maturities, removing pressure on public debt in the short term, In July, the Treasury repurchased €763 million of debt maturing in 2023 and 2024 and sold debt maturing in 2028 and 2035.
- The sovereign risk premium has increased following the end of net asset purchases, but we expect it to remain within reasonable bounds supported also by the ECB new anti-fragmentation tool, Apart from active debt management, the positive evaluation from the several rating agencies and the strong sign given by the government regarding fiscal consolidation and reduction of the public debt ratio, will probably also cushion risk premia going forward.

The Portuguese banking system: In a solid position to face a more stressed environment (1)

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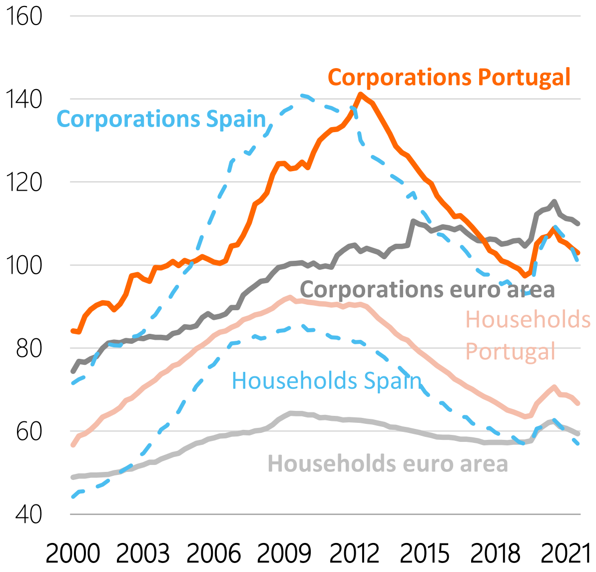
Gross private debt

% of GDP, non consolidated debt,



Source: ECB, Eurostat.
Gross private debt includes: loans fron FI and others+ debt securities.

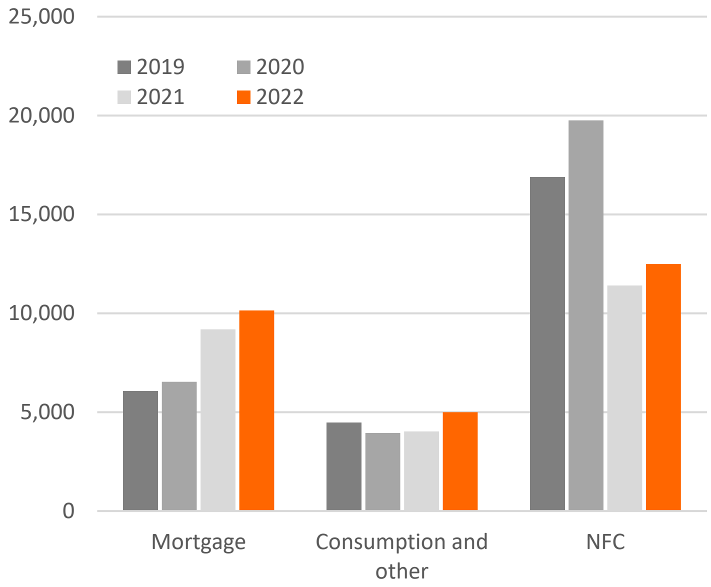
Private domestic credit

Year on year (%)

	Aug 2021 % yoy	Aug-2022 % yoy	2022 (For.) % yoy
Credit to the non-financial private sector	**4.2%**	**2.1%**	**1.5%**
Households	3.0%	3.5%	2.4%
Housing mortgages	3.0%	3.6%	2.7%
Other purposes	3.0%	3.2%	1.5%
Consumer lending	0.1%	7.6%	5.5%
Non-financial corporations	6.2%	-0.3%	0.0%

New lending activity by sector

Accumulated in the year (up to August), Bn euros



Source: Bank of Portugal.

- **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.
- **Up to August 2022, new operations showed a positive trend:** new credit for NFC and households increased 9,5% and 14,6%, respectively, but is showing signs of deceleration, specially NFC. Mortgage credit continues very strong even if it is slowing down. However, interest rates on new mortgage credit have started to increase, reflecting monetary policy normalization. This increase, as well as the setback in confidence after the Ukraine war, could cool down the new mortgage credit operations going forward. Regarding NFC, credit outstanding will decline due to the progressive maturity of Covid-credit lines and also due to moderate demand of new credit, as companies' budgets are constrained by high inflation and increasing interest rates.

The Portuguese banking system:
In a solid position to face a more stressed environment (2)

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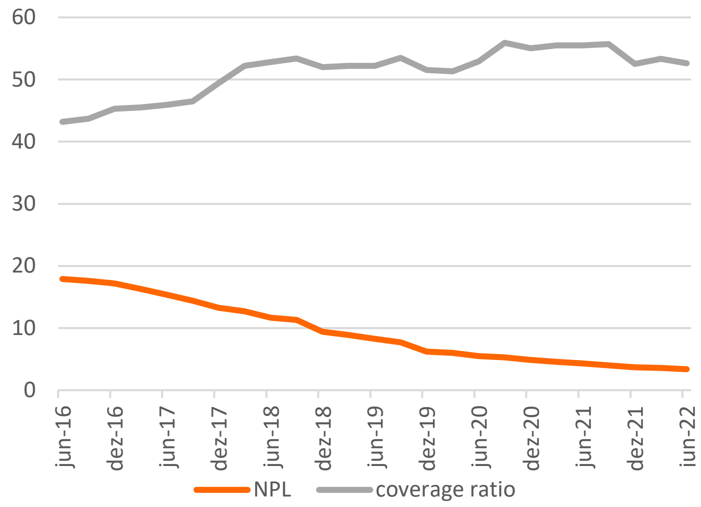
NPLs and coverage ratios

% **NPL ratio**[1]
In % of gross loans

Coverage ratio
In % of NPLs



Cost of risk[1]
0,5% in 2019
0,2% in Q2 2022

Note (1): flow of impairments to credit as a percentage of total gross.
Source: Bank of Portugal.

Banks' profitability

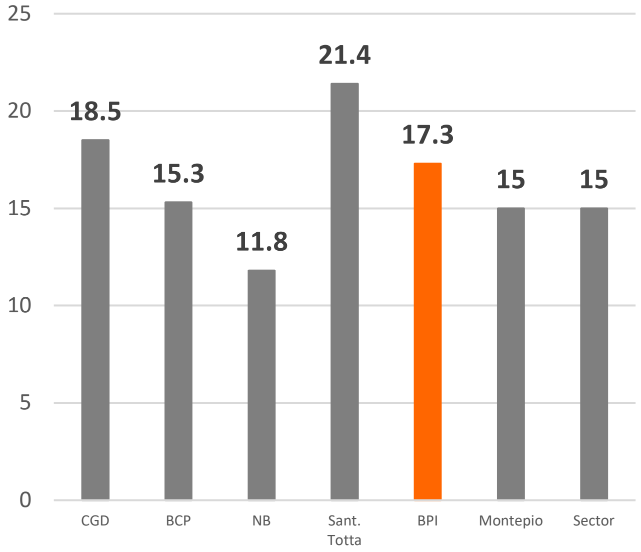
In % of average total assets (H1 22; trailing 12M)

	BPI	BCP	San Totta	CGD	NB	Montepio
Net interest income	**1.1%**	**1.3%**	**1.2%**	**0.8%**	**1.2%**	**1.2%**
Net fees	0.7%	0.8%	0.8%	0.5%	0.6%	0.6%
Gains on financial assets	0.1%	0.2%	0.1%	0.1%	0.4%	0.2%
Other net profits	-0.2%	-0.2%	-0.1%	-0.1%	0.2%	-0.2%
Gross income	**1.8%**	**2.2%**	**2.0%**	**1.4%**	**2.4%**	**1.8%**
Operating expenses	-1.1%	-0.9%	-0.8%	-0.8%	-0.9%	-1.2%
Operational result	**0.7%**	**1.3%**	**1.2%**	**0.7%**	**1.5%**	**0.6%**
Impairment losses, taxes and others	-0.1%	-0.6%	-0.1%	0.5%	-0.1%	-0.1%
Profit	**0.4%**	**0.5%**	**0.8%**	**0.8%**	**1.2%**	**0.2%**
ROTE[1]	9.0%	2.8%	10.5%	11.5%	nd	nd

Notes: 1) the values for BCP and CGD refer to ROE; calculation methodologies differ between banks.

Banks' solvency and liquidity position

In % (Q2 22)



Source: Banks publications, BoP

- **NPLs continue to decline, despite the fact that debt moratoria have already expired.** The NPL ratio declined by 2 tenth to 3,4% in 2Q22,
- **Profitability is improving on a moderate basis, exceeding levels in the pre-pandemic period (ROE stood at 8,4% in 1Q22 and 5,4% in 4Q21 at the consolidated level). In addition, the expected path for interest rates represent a tailwind for Portuguese banks.**
- **The capital position of Portuguese banks provides buffers against the risks that could arise due to the conflict in Ukraine. The CET1 ratios remain above the regulatory minimum.**

BPI

Grupo CaixaBank