Deficit and debt scenarios: some key considerations

Public accounts continued to improve in 2017, if we exclude the effect of the recapitalization of Caixa Geral de Depósitos (one-off effect). The deficit reached the lowest level (at least) since 1974 (-0.9% of GDP), benefitting from the favorable economic environment in 2017, the low funding costs and the control of the public expenditure. At the same time, benefiting from the primary surplus, economic growth and the reduction of interest charges, the public debt ratio decreased to 125.7% of GDP at the end of 2017, a key development for the assessment of foreign investors and institutions.

The scenario outlined in the Stability Program for the period 2018-2022 reveals a commitment to maintain the consolidation of public accounts, with the Government anticipating a budget surplus in 2020, and the public debt ratio falling to 102% of GDP in 2022. Although we consider this scenario to be too optimistic, the assumptions presented for 2018-2019 are quite plausible, configuring the continuity of the path of fiscal consolidation and the reduction of public indebtedness, albeit at a pace somewhat slower than that implicit in the official scenario. However, there are some risks: external (global growth, global risk perception) and domestic (evolution of economic activity and eventual unexpected financial support to banks).

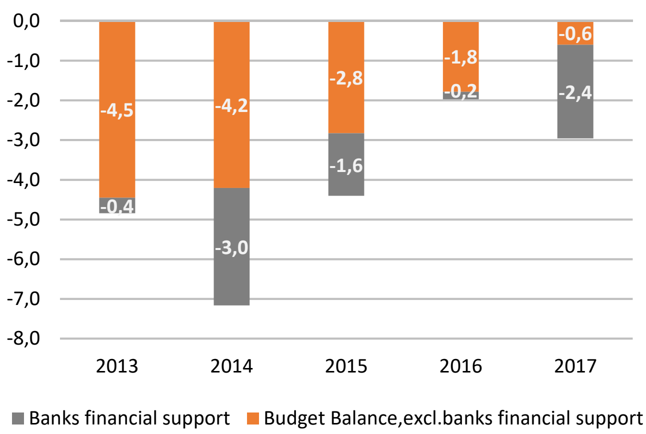
This more favorable scenario has led some institutions to review their forecasts for Portugal, such as the IMF, and international rating agencies to be more positive about the path outlined so far and to assess the future of the country in a more optimistic way, like the DBRS.

1. Significant reduction of the deficit in 2017

In 2017, the general government budget deficit reached the lowest level since 1974 (-0.9% of GDP, excluding one-off effects[1]). This evolution contrasts with the recent past performance: Portugal broke the 3% of GDP ceiling rule for the budget deficit practically since 2009, prompting the European Commission to put the country into the Excessive Deficit Procedure in that year (the corrective arm of the Stability and Growth Pact[2]). During the process, the recognition of Public Entities debt and high budget deficits led to a significant increase of the debt ratio as a percentage of GDP. **The effort to consolidate the public accounts during the adjustment program and in the subsequent years**

Portugal: budget deficit, with banks support

% GDP



Source: BPI Research, based on Datastream and INE.

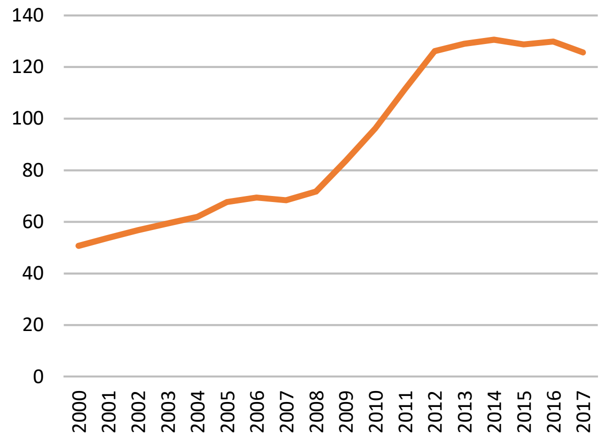
[1] The official value for the fiscal deficit is 3.0% of GDP, including the recapitalization of Caixa Geral de Depósitos, whose impact reached 2.0% of GDP.
[2] EDP: procedure that is activated when a Member-State fulfills one of the following situations: (i) the government deficit exceeds or is in danger of exceeding the 3% of GDP limit; or (ii) the government debt ratio surpasses the 60% of GDP, and it is not declining at a satisfactory pace.

allowed Portugal to reach a deficit of less than 3.0% in 2016, allowing the exit of the EDP and the entry into the preventive arm of the SGP[3].

The economic recovery supported the improvement of public accounts in 2017, boosting the collection of tax and contributory revenues. At the same time, it is also worth noting the expenditure control, in comparison to the levels estimated by the Government, which is visible in almost all the items. Expenditure stood below the projection inscribed in the State Budget 2017: -1.3 percentage points of GDP. On the other hand, the low level of interest rates and the significant reduction of the sovereign risk premium allowed the financing of debt with very favorable costs, contributing to the reduction of interest charges. **In line with the surplus of the primary balance (3.0% of GDP, excluding the CGD effect), the economic growth and the reduction of interest charges, the public debt ratio decreased by 4.2 p.p. to 125.7% of GDP at the end of 2017.**

Portugal: Public Debt

% of GDP



Source: BPI Research, based on Bank of Portugal's figures.

2. Stability Program optimistic in the long-term

The macroeconomic scenario outlined in the Stability Program 2018-2022 reveals an economic growth rate always above the 2% in the projection horizon. The forecasts for economic growth registered in the SP compares favorably with those mentioned by the Government in previous documents, especially justified by the stronger behavior of Investment and Exports. At the same time, unemployment rate was substantially revised downwards, in comparison to the SP 2017-2021 (for example, the Government revised the unemployment rate to 7.6% in 2018, from 9.3% in the previous Stability Program).

Macroeconomic Scenario inscribed in the Stability Program 2018-2022

	SP 2018-2022					SP 2017-2021			
	2018	2019	2020	2021	2022	2018	2019	2020	2021
GDP (real, %)	**2.3**	**2.3**	**2.3**	**2.2**	**2.1**	**1.9**	**2.0**	**2.1**	**2.2**
Private Consumption	2.0	2.0	2.0	2.0	2.0	1.6	1.6	1.6	1.6
Public Consumption	0.7	-0.1	-0.1	-0.2	0.0	-0.8	-0.9	0.0	0.5
Investment	6.2	7.0	7.1	6.4	5.5	5.1	5.1	4.8	4.7
Exports	6.3	4.8	4.2	4.2	4.2	4.5	4.5	4.5	4.5
Imports	6.3	5.0	4.5	4.5	4.4	4.1	4.1	4.1	4.1
Inflation rate (%)	**1.4**	**1.4**	**1.4**	**1.7**	**1.7**	**1.7**	**1.7**	**1.8**	**1.8**
Unemployment rate (%)	**7.6**	**7.2**	**6.8**	**6.5**	**6.3**	**9.3**	**8.6**	**8.0**	**7.4**

Source: BPI Research, based on Stability Program 2018-2022.

BPI Macroeconomic Scenario

		Actual			
	2017	2018P	2019P	2020P	2021P
PIB real	2.7	2.4	2.3	2.2	1.8
Inflação (IHPC)	1.6	1.0	1.5	1.8	2.0
Taxa de desemprego	8.9	7.6	6.9	6.4	6.0

Source: BPI Research.

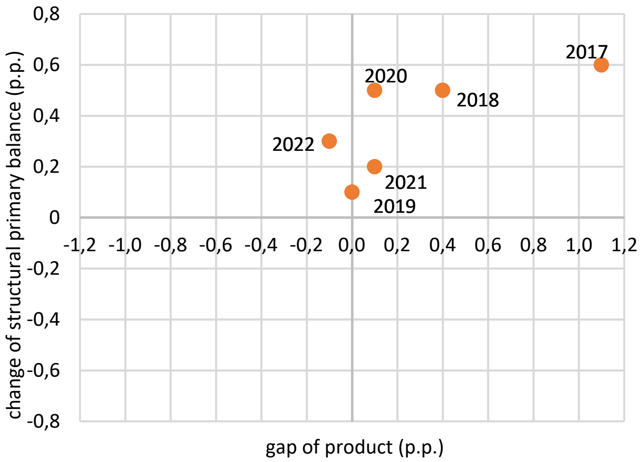
In the long term, the Executive's scenario is more optimistic than that of BPI: between 2020 and 2022, the average economic growth rate estimated by the Executive is 2.2%, which compares with the BPI forecast of 1.9% for the same period. For the remaining variables, we highlight the more positive evolution of the inflation rate (measured by the CPI) and the employment growth rate (average growth of 1.1% between 2018 and 2022 vs. 0.8% in the BPI scenario).

[3] In the case of Portugal, the preventive arm requires a structural adjustment of at least 0.6% of GDP per year, until a structural balance of + 0.25% is achieved.

3. Commitment with fiscal consolidation

The consolidation of public accounts is expected to continue over the next few years, with the government revising the projected budget balance for this year from -1.1% to -0.7% and anticipating a surplus in 2020 (0.7%). Considering the data projected by the Government, **fiscal policy should be restrictive and counter-cyclical in the coming years**, in line with the medium-term objective (MTO), which establishes that Portugal should reach a structural balance of + 0.25% of GDP. The government expects to reach this target in 2020 (+ 0.3%), an estimate that may be too optimistic, given the difficulty to make adjustments in a context of economic slowdown[4]. Estimates for the budget balance differ from the more conservative BPI outlook: the positive performance of public accounts in 2017 is expected to have a positive impact this year; the macroeconomic scenario is estimated to remain favorable, boosting fiscal revenues; furthermore, the Government has some leeway/flexibility to adjust capex (investing less than planed); and an underestimation of tax and contributory revenues, according to our calculations. However, the political cycle and the need to approve the State Budget for 2019 in the current parliamentary framework may put some pressure on public accounts.

Fiscal Policy and Economic Environment



Source: BPI Research, based on Stability Program 2018-2022.

The sources of risk to the scenario outlined by the Government can be of external or domestic origin. On the external side, we point the political issues, geopolitical tensions and financial events worsening of risk appetite, and consequent **impact on the sovereign risk premium.** At this point, it is important to consider that the Executive anticipates a 5.7% decrease of interest charges in 2018[5], the equivalent to a saving of EUR 426 million compared to the one executed in 2017, higher than that projected by the Government in the SB 2018 proposal (EUR 307 millions). In the domestic sector, we highlight the expectation for the tax and contributory revenue, **depending on the evolution of the economic environment and the labor market, and possible financial support to the banking system** that has not previously been safeguarded[6].

Public Accounts*

% GDP	2017	2018	2019	2020	2021	2022	Var.p.p. 2022/18
Overall Fiscal Balance	**-0.9**	**-0.7**	**-0.2**	**0.7**	**1.4**	**1.3**	**2.0**
Tax Revenues	25.2	25.1	24.9	24.8	24.7	24.7	-0.4
Social Security Contributions	11.8	11.8	11.8	11.8	11.9	11.9	0.1
Other	5.9	6.3	6.2	6.3	6.6	6.1	-0.2
Total Revenue	**42.9**	**43.2**	**42.9**	**42.9**	**43.2**	**42.7**	**-0.5**
Social Benefits	18.4	18.3	18.2	17.9	17.8	17.7	-0.7
Compensation of Employees	11.0	10.8	10.6	10.4	10.2	10.0	-0.8
Interests	3.9	3.5	3.4	3.2	3.1	3.1	-0.4
Investment	1.8	2.3	2.4	2.6	2.6	2.6	0.3
Other	8.7	9.1	8.5	8.2	8.1	8.1	-0.9
Total Expenditure	**43.8**	**43.9**	**43.0**	**42.2**	**41.7**	**41.4**	**-2.5**

Note: * Figures for 2017 were corrected by CGD's effect.
Source: INE; Ministry of Finance.

[4] Government projections show that it will not be possible to meet the minimum reduction of 0.6 p.p. of GDP per year in 2018 and 2019.
[5] Stability Program 2018-2022.
[6] The need to lend to the Resolution Fund to improve the capital ratios of the Novo Banco was already foreseen in the SB 2018 (EUR 850 million to be applied in the financial system). Novo Banco will need EUR 450 million, so there remains a financial cushion of EUR 400 million.

The official forecast for the public debt ratio is 122.2% this year, justified by the effect of the primary balance (explaining 80% of the expected reduction in the public debt ratio), along with the evolution of economic activity, which should largely offset the negative (although decreasing) impact of interests. The Government also expects that the debt ratio reaches 102% of GDP in 2022. Nonetheless, **public debt and interest charges remain at high levels, which may continue to constrain the fiscal space to absorb any adverse shocks in the short and medium term.**

4. What do the main world institutions say about Portugal?

The improvement of economic, fiscal and financial situation led the rating agencies to review their assessments of Portugal, initiated by S&P last year. More recently, the DBRS revised the rating of Portugal to BBB, from BBB-, with a stable outlook. According to the agency, the most positive evaluation for the public debt trend, the sustainable improvement of the public accounts, along with the maintenance of fiscal discipline supported this change. At the same time, the economy continued to grow at a steady and positive pace (according to the agency, risks for the short-term growth are low and are mainly related to external factors), and the reduction of NPL ratio in the banking system. However, the agency also points out some vulnerabilities and / or challenges in the fiscal area: (i) high expenditure on the health sector; (ii) some state-owned enterprises remain unprofitable; (iii) some of the temporary austerity measures were reversed, which can put pressure on public spending in the future; (iv) persistent delays in payments to hospitals.

Rating attributed for the main rating agencies*

	Rating	Last update change	Outlook
Moody’s	Ba1	25/07/2014	Positive
S&P	BBB-	15/09/2017	Stable
Fitch	BBB	15/12/2017	Stable
DBRS	BBB	20/04/2018	Stable

Note: (*) Rating for the long-term foreign currency debt.

Source: BPI Research, based on Bloomberg.

Moody's recently maintained the rating attributed to the Portuguese public debt in Ba1. The agency justifies this decision with the still high private and public debt and the weak banking sector. However, Moody’s also consider that the rating should not move down over the next 12-18 months. The maintenance of the rating, which was surprising, did not, however, have any impact on the spread, which remains at reduced levels (slightly above 100 basis points).

The IMF anticipates a slower improvement in public accounts. The latest IMF forecasts show a less positive estimates for the budget balance, anticipating that it will reach -1.0% this year and decline to -0.6% in 2022[7]. The IMF also estimates that the primary balance will exceed 2.0% of GDP by 2022, but it will gradually decline. The Fund is more optimistic than the Government for the debt ratio by 2020, anticipating a decrease to 107.7% of GDP in 2022.

[7] The April’s WEO figure is -1.2% of GDP in 2017, different from that published by INE, so these figures may have been estimated prior to the publication of the budget balance for 2017.

Banco BPI, SA - 2018

Rua Tenente Valadim, 284 4100-476 Porto Telef.: (351) 22 207 50 00 Telefax: (351) 22 207 58 88

Largo Jean Monnet, 1-9º 1269-067 Lisboa Telef.: (351) 21 310 11 86 Telefax: (351) 21 315 39 27 www.bancobpi.pt