Portugal: Tough Times Ahead

■ **Portugal's fiscal problems, while not as acute as Greece's, are chronic.**

■ **The government enjoys higher credibility regarding fiscal consolidation…**

■ **…and previous reforms have significantly reduced the burden of demographic trends on age-related spending.**

■ **Lack of competitiveness is Portugal's main problem.**

■ **In the absence of further aggressive supply-side reforms, for which we do not perceive appetite to be strong at the moment, growth is likely to remain anaemic and inflation low or even negative for a protracted period.**

■ **This will probably frustrate any attempt to consolidate public finances...**

■ **…making Portugal vulnerable to possible negative shocks.**

■ **While overall coherent, the latest Stability and Growth Programme was too timid and probably represents a lost opportunity to use increased external pressure to put the public finances onto a more solid path.**

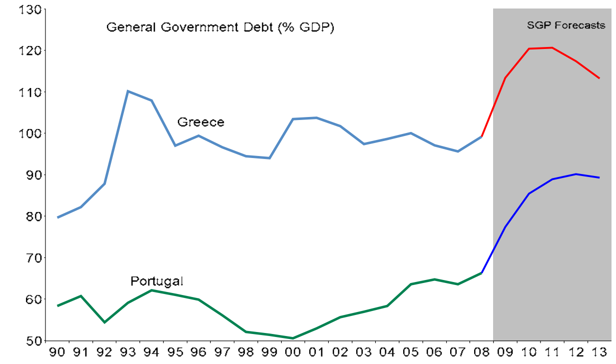
As market pressure for fiscal adjustment increased, we engaged in a tour of European capitals in order to get a better understanding of the willingness of politicians and societies as a whole to undertake the adjustment needed to return to a sustainable fiscal path over the long term. Our first stop was Lisbon where, in contrast with our previous visits, the mood amongst our hosts was subdued. There was awareness that the economy will have to face tough times, not least because of the needed adjustment in public finances. But we did not perceive any sense that this could trigger a strong political and social push to implement badly needed structural reforms. In one word: resignation. Below is a summary of the main conclusions we drew from our meetings with representatives of Portuguese business and the political establishment.

Portugal versus Greece

The association with Greece is overly simplistic on at least four grounds:

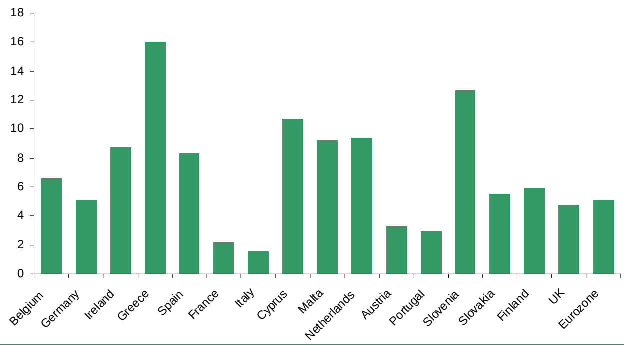
i. First, levels of public deficit and debt are considerably lower in Portugal than in Greece (Chart 1). This is even when accounting for some below-the-line accounting entries such as the debt of a number of Portuguese public companies that, according to local economists, could total as much as 15% of GDP.

Chart 1: Gross Public Debt (% of GDP)



Source: Reuters EcoWin Pro, National Stability and Growth Programmes for the forecasts

Chart 2: Age-Related Public Expenditure (Change 2010-2060, % of GDP)



Source: EU Commission

ii. Portugal enjoys higher credibility than Greece with regard to fiscal consolidation, reflecting the adjustment undertaken between 2003 and 2007. The same applies to fiscal statistics. Markets still have considerable doubts over the credibility of Greece's fiscal accounts.

iii. Unlike Greece, Portugal has already undertaken an overhaul of the social security system through a) the introduction of a sustainability factor; b) the introduction of new incentives to lengthen working life; c) a closer link between contributions and pension benefits; d) the convergence of the rules applicable to public employees to the Social Security General Scheme; and d) new rules regarding annual pension updating.

While not immediate, the impact of these reforms will be felt in the future, significantly limiting the burden of unfavourable demographic trends on public finances. According to estimates from the EU Commission, in the absence of new reforms, age-related public spending will increase by a stunning 16% of GDP in Greece between 2010 and 2060. This compares with the eurozone average of 5.1% and only 2.9% in Portugal (Chart 2); and

iv. Last but not least, social opposition to further fiscal consolidation measures is likely to be more moderate than in Greece, as past experience over the period 2003-2007 shows. Even the weakness of the government, which does not enjoy a majority in the parliament, is not seen as a significant hurdle to fiscal consolidation. The opposition opted for abstention in the vote for the 2010 budget and will do the same when the Stability and Growth Pact is debated next week.

In sum, the effort required in order for Portuguese fiscal trends to return to a sustainable path, while significant, is less dramatic than for Greece, and easier to implement socially. Moreover, the rollover of debt is lower delivering a far lower liquidity threat to funding. Combined with past successes in fiscal consolidation, this underpins the higher credibility Portugal enjoys compared to Greece regarding fiscal future prospects.

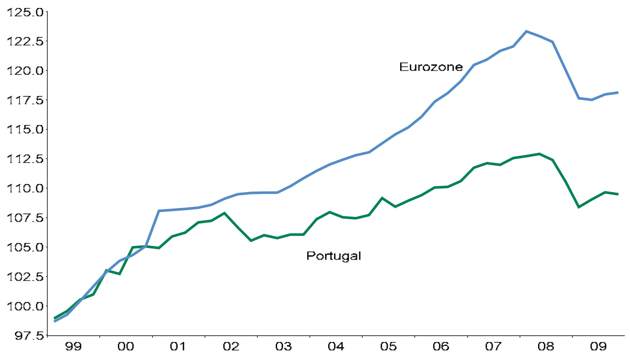
It is all about growth, or lack of it

Defending this credibility will not be an easy task, however. Growth over the past decade has been sluggish despite strong leveraging by the private sector and a boom in Portugal's main trading partner, Spain. Real GDP growth slowed to levels below the eurozone average, implying an interruption of the real convergence process (Chart 3).

The major factor underlying this weak performance is lack of competitiveness that shows up in a persistent and increasing imbalance between the domestic investment and domestic saving levels, thereby leading to an increase in net external borrowing requirements.

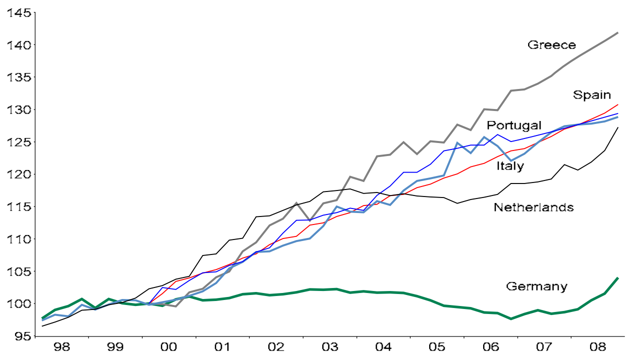
This reflects, amongst other factors, unfavourable developments in unit labour costs compared to Portugal's competitors. According to an analysis by Banco de Portugal, the official figures on which Chart 4 is based tend to overestimate the cost competitiveness gap (for example, they treat pension contributions in the public sector as a labour cost). But, even accounting for these factors, the gap remains significant. Other aspects, such as heavy bureaucracy, a slow judicial system, barriers to entry such as licensing and the low level of human capital due to the relatively weak level of education play an important part too. This conclusion is supported by another study from the Portuguese central bank[1], which suggests that most of the growth slowdown from the previous decade was due to total factor productivity, reflecting structural fragilities such as the low level of education of the labour force and a cumulative decline in investment.

Chart 3: Real GDP (Index, 1999 = 100)



Source: Reuters EcoWin Pro

Chart 4: ULCs (Index, 1999 = 100)



Source: Reuters EcoWin Pro

These factors have been recently emphasised by the entry into global trade of a number of economies with a product specialisation similar to Portugal, leading to a decline in Portuguese market share. The picture is aggravated by the significant share of Portuguese exports (25% of the total) going to Spain, which is undergoing a similar structural adjustment and as such is likely to experience a slowdown in growth following the exceptionally strong performance of the last decade. Increased export penetration in countries with high growth potential (such as Angola, Algeria, Venezuela, Tunisia and Mozambique) offers a counterbalancing factor. But their weight in total exports is still limited and unlikely to offset the impact of anticipated sluggish growth in more traditional export markets (Spain, Germany, France and the UK account for around 55% of total Portuguese exports).

[1] See "The Portuguese Economy in the Context of Economic Financial and Monetary Integration", Economics and Research Department, Banco de Portugal, 2009.

High but sustainable debt

In the recent past, the above-mentioned weaknesses have been partially offset by the higher indebtedness of the private sector due to very favourable financing conditions (as low interest rates combined with a lengthening of loan maturities, Chart 5).

The Portuguese authorities outlined that high private indebtedness was not regarded as an imminent threat and we agree. Around 75% of individuals' debt relates to loans for house purchases with relatively low mortgage loan-to-value (LTV) ratios. Households' wealth/debt ratios remain elevated. Moreover, the debt service ratio, which measures the proportion of households' income assigned to the payment of interest and repayment of capital, has remained contained. In particular, in Portugal the debt service ratio for low income households is much lower than in other eurozone countries.

In addition, Portugal has not experienced a construction boom, with house prices broadly stagnant over the past few years. Following a peak in 2001, the weight of construction activity on GDP has progressively fallen over the past few years to levels close to the eurozone average (Chart 6). This also reflects positively on the banking sector, which has been relatively resilient to the financial crisis.

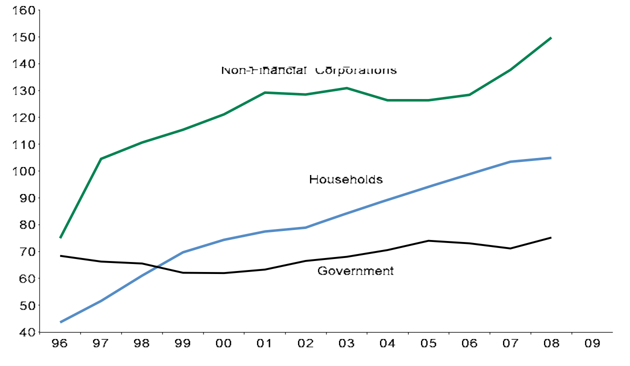
Notwithstanding these factors, high private sector debt leaves Portugal in a fragile position. As a result of the financial crisis, banks have adopted more stringent criteria leading to shortening in maturities, lowering of LTV ratios and an increase in spreads. This will increasingly weigh on households' finances. Combined with low consumer confidence and high unemployment, it is likely to lead to progressively higher savings at the same time as public finances are adjusted, with a significant fallout on growth.

Which exit?

Typically, in such a scenario, the currency takes a hit, allowing the economy to gain competitiveness and sharing the burden of the fiscal adjustment with foreign countries. This is what happened for example in Sweden in the early 1990s. The currency depreciation (around 20% in effective terms) led to double-digit increases in exports as the financial crisis was unravelling. But this road is precluded in Portugal due to the common currency.

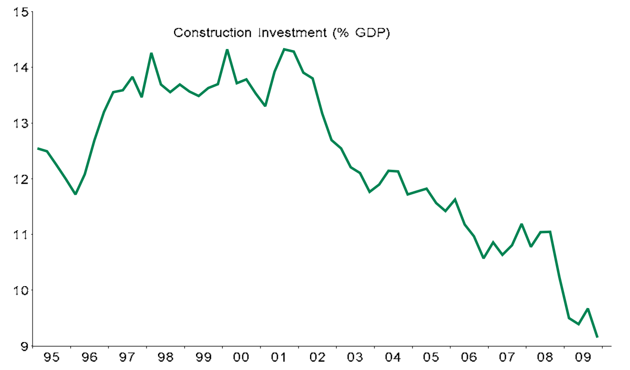
A possible alternative is represented by aggressive supply-side reforms aimed at increasing the potential growth rate of the economy. Indeed, Portugal has implemented a number of significant reforms over the past few years including initiatives to increase human capital, simplify public administration procedures, increase R&D, reduce external energy dependency and enhance infrastructure. But the main obstacle to a more dynamic business environment is the strict

Chart 5: Portuguese Financial Liabilities (% of GDP)



Source: Reuters EcoWin Pro

Chart 6: Housing Investment as % of GDP



Source: Reuters EcoWin Pro

regulation of the labour market. As Chart 7 shows, Portugal has one of the strictest employment protection regimes across OECD countries. The bad news is that we perceived little appetite for labour market reforms even in the opposition ranks, given their high unpopularity.

Against this backdrop, an adjustment process may be forced by economic forces through a real currency depreciation, which, in the absence of flexibility in the nominal exchange rate, could materialise via a disinflationary process towards the eurozone average. Given the prospects of a prolonged period of low inflation in the eurozone as a whole, this implies a high risk of deflation in Portugal, and, we would argue, in a number of other eurozone economies which are undertaking similar adjustments.

The implications for public finances are important. Under a scenario of sluggish growth and low or even negative inflation, the fiscal adjustment required to return to a sustainable path is, other things being equal, greater and thus harder to implement from a social and political point of view. An example is provided by the need to cut public spending on wages. If inflation is high, a cut in real wages can be realised, letting them rise at a slower pace than average inflation. If deflation sets in, cuts in *real* wages (and more generally in real public spending), require cuts in *nominal* wages, that are likely to encounter more aggressive social opposition.

The Stability and Growth Programme

This leads us to the Stability and Growth Programme that the Portuguese government published last week following intense negotiations. The plan envisages a progressive reduction of the public deficit to 2.8% of GDP in 2013 from 9.3% in 2009. The correction is back-loaded (with a planned decline in the deficit of only 1% of GDP this year), which we view as a positive. Unlike Greece, Portugal does not need to regain credibility and may allow growth to become more sustainable before acting aggressively on the fiscal front.

Amongst other positive elements, around half of the adjustment (49%, Chart 8) will come from cuts in expenditure (including a reduction in the public sector wage bill and cuts in public investments) and only a small portion (15%) from increases in revenues (a new tax rate for incomes above EUR 150mn and an increase in capital gains tax).

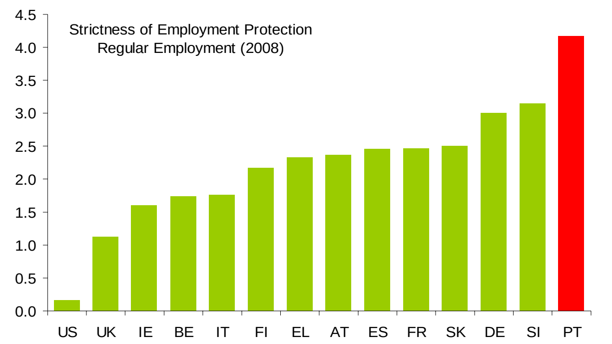
The main drawback of the plan is that the remaining 36% is left to automatic stabilisers. This is particularly risky in the current environment. Most of our Portuguese hosts emphasised that the plan is based on conservative growth assumptions, a consideration that we share (even though risks to the assumptions are still biased to the downside in our view). However, this was compensated by overly-optimistic assumptions on inflation, with HICP inflation (there is not yet a specific assumption on the GDP deflator) expected to return to around 2% as early as 2011. We believe inflation will turn out significantly lower than this, which is likely to lead to disappointment on the revenue side.

The government also expects around EUR 6bn worth of privatisation revenues by 2013, a figure that most of our interlocutors found overly optimistic. Overall, therefore, we believe the plan was timid. Some officials emphasised that, in the event of failure, a Plan B including tax increases would be considered but our suspicion is that the opposition, whose implicit approval is needed for the budget to pass, would object to this solution – rendering it unviable.

Conclusions

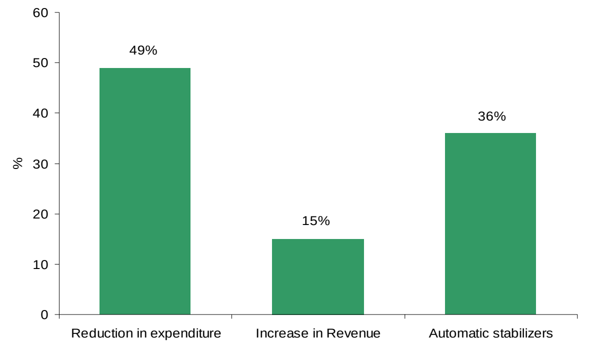
The fiscal outlook in Portugal, while considerably better than in Greece, is still troublesome. Portugal's problems are not so acute but have proved persistent. Lack of fiscal discipline over the past few years was an important cause of the situation Greece is now facing. Conversely, Portuguese fiscal imbalances are the result of low growth due to the structural lack of competitiveness. The Portuguese

Chart 7: Strictness of Employment Protection Index



Source: OECD

Chart 8: SGP – Contributions to Total Budget Adjustment (2010-1013)



Source: Portugal's Stability and Growth Programme

authorities enjoy higher credibility due to the successful fiscal adjustment undertaken in the period 2003-2007. The problem is that, against the backdrop of high indebtedness in the private sector and in the absence of aggressive structural reforms (for which we did not perceive a great appetite at this time), growth will remain low and so will inflation. This will probably frustrate any attempt to structurally improve public finances, leading to a slow but progressive upward drift in the public debt.

Against this backdrop, the outlook for Portugal appears vulnerable to possible negative shocks both domestically (there is a high chance of a downgrade of its sovereign debt from the main rating agencies over the next few months) and from abroad (a new wave of concern over fiscal imbalances triggered by Greece or the UK, for example). External pressure triggered by the Greek crisis offered an opportunity to the Portuguese government to accelerate fiscal consolidation, counting on a more favourable internal reaction. Against this backdrop, the SGP was too timid and has probably been a lost opportunity to put the public finances onto a more solid path.

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