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# The economy and the banking sector: recent developments



*Banco de Portugal*

**VÍTOR CONSTÂNCIO**

**The Economist Business  
Roundtable, Lisbon 22 January 2008**

- **Macroeconomic outlook**
- **Consolidation of Public Finance**
- **Banking and Financial Stability issues**

# Main features of the economic outlook

- A continued moderate **recovery of economic activity** in 2008 and 2009.
- A **decline in inflation** to 2 per cent in 2009.
- A **correction of macroeconomic imbalances**. A **decline in the net external borrowing requirements**, reflecting the rebound in the households' saving ratio and the reduction in the fiscal deficit.
- On the supply side, **total factor productivity growth is estimated to play a prominent role** reflecting higher capacity utilisation rate and the restructuring in the corporate sector.
- On the demand side, **the acceleration in economic activity is shaped by domestic demand**, since exports are projected to be less buoyant than in 2006 and 2007, evolving broadly in line with external demand.
- The current projection embodies **higher than usual uncertainty** and clear **downward risks for economic activity** related mostly with the international economic and financial situation.

# Outlook for the Portuguese economy 2008-2009\*

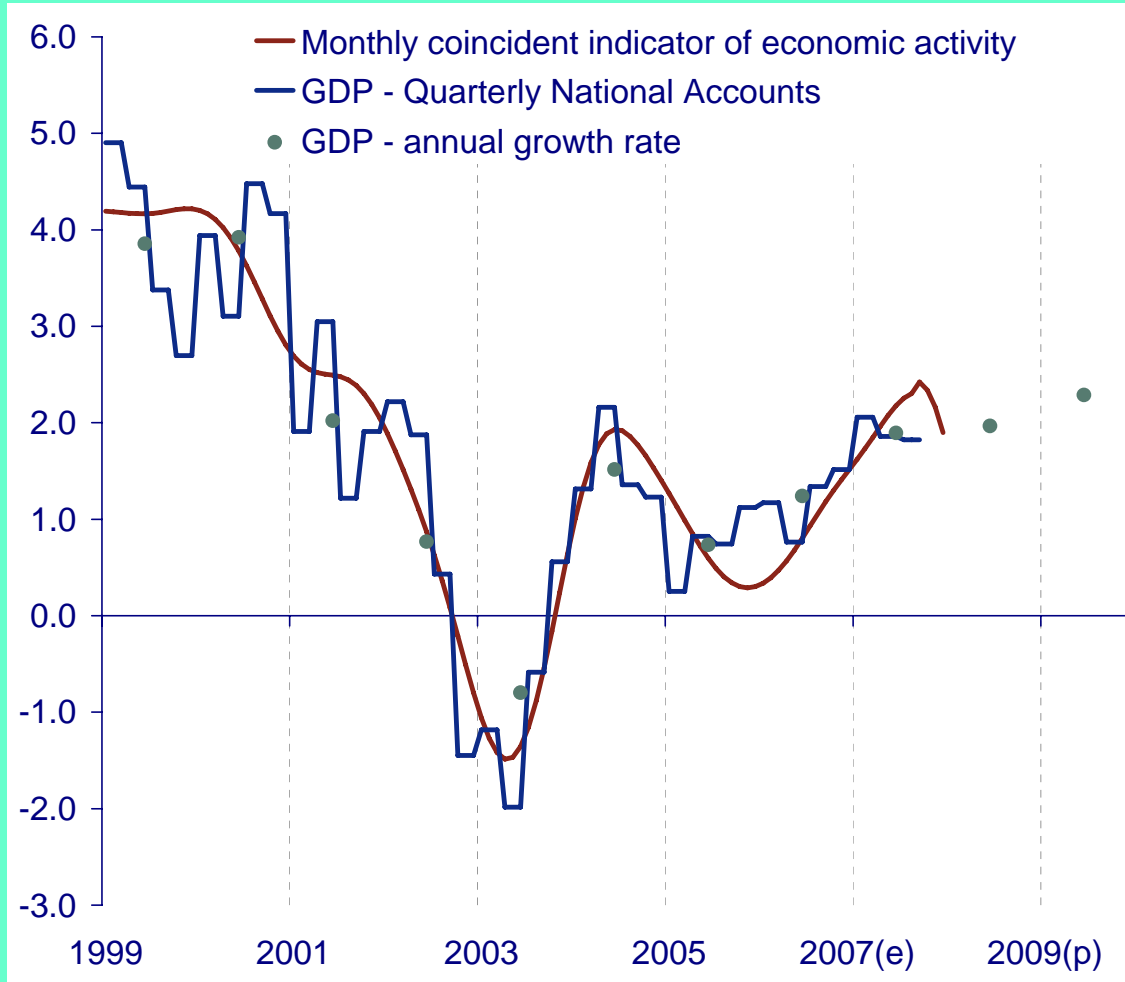
	2006	2007(e)	2008(p)	2009(p)
Real GDP	1.2	1.9	2.0	2.3
Private consumption	1.2	1.2	1.1	1.6
Government consumption	-0.7	0.0	0.0	0.4
Gross fixed capital formation	-1.8	2.6	3.3	3.1
Exports	9.1	7.0	4.9	6.0
Imports	4.3	4.1	2.9	3.7
Current + capital account (% of GDP)	-8.6	-8.2	-7.3	-6.4
HICP	3.0	2.4	2.4	2.0

\*Published in the Banco de Portugal Winter 2007 Economic Bulletin, Jan 08

# GROWTH FORECASTS FOR PORTUGAL

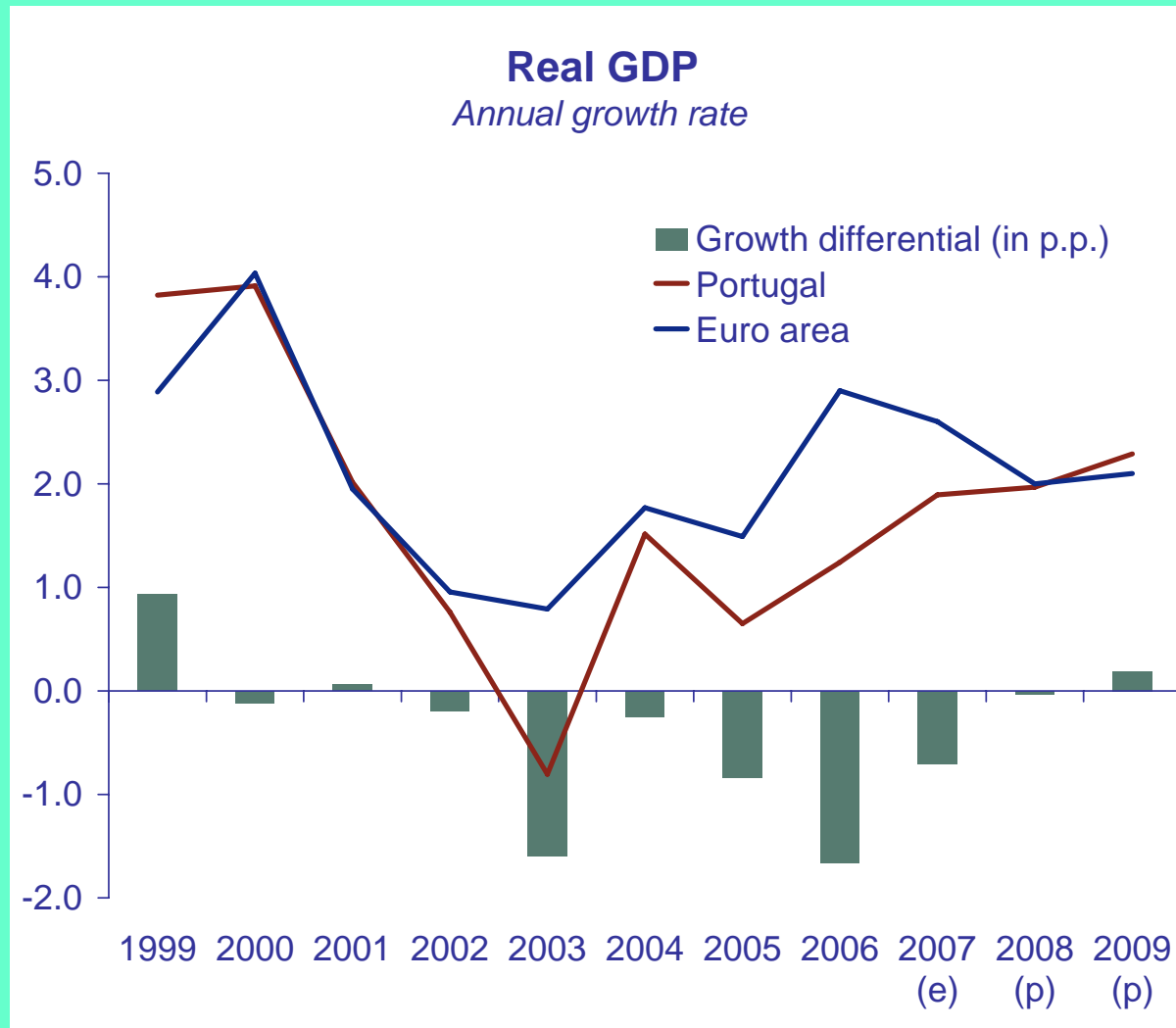
	Date	2007	2008	Revision for 2008 in relation to previous	Date of previous forecast
<b>GOVERNMENT</b>	<b>Oct 07</b>	<b>1.8</b>	<b>2.2</b>	<b>- 0.2</b>	<b>Jun 07</b>
<b>BANCO DE PORTUGAL</b>	<b>Jan 08</b>	<b>1.9</b>	<b>2.0</b>	<b>-0.2</b>	<b>Jul 07</b>
<b>EUROPEAN COMMISSION</b>	<b>Nov 07</b>	<b>1.8</b>	<b>2.0</b>	<b>-0.0</b>	<b>Apr 07</b>
<b>IMF</b>	<b>Oct 07</b>	<b>1.8</b>	<b>1.8</b>	<b>-0.2</b>	<b>Aug 07</b>

- **Banco of Portugal's Coincident Indicator of economic activity fell sharply in December**



# Main features of the projection

- Economic activity is projected to grow at rates close to the euro area in 2008 and in 2009.



# Underlying assumptions

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	2007	2008	2009
Short-term interest rate (annual average)	4.3	4.5	4.1
Effective exchange rate (annual average appreciation)	3.9	3.5	0.0
Oil price (\$US/bbl - annual average )	72	89	86
External demand (annual average growth)	5.7	5.4	5.7

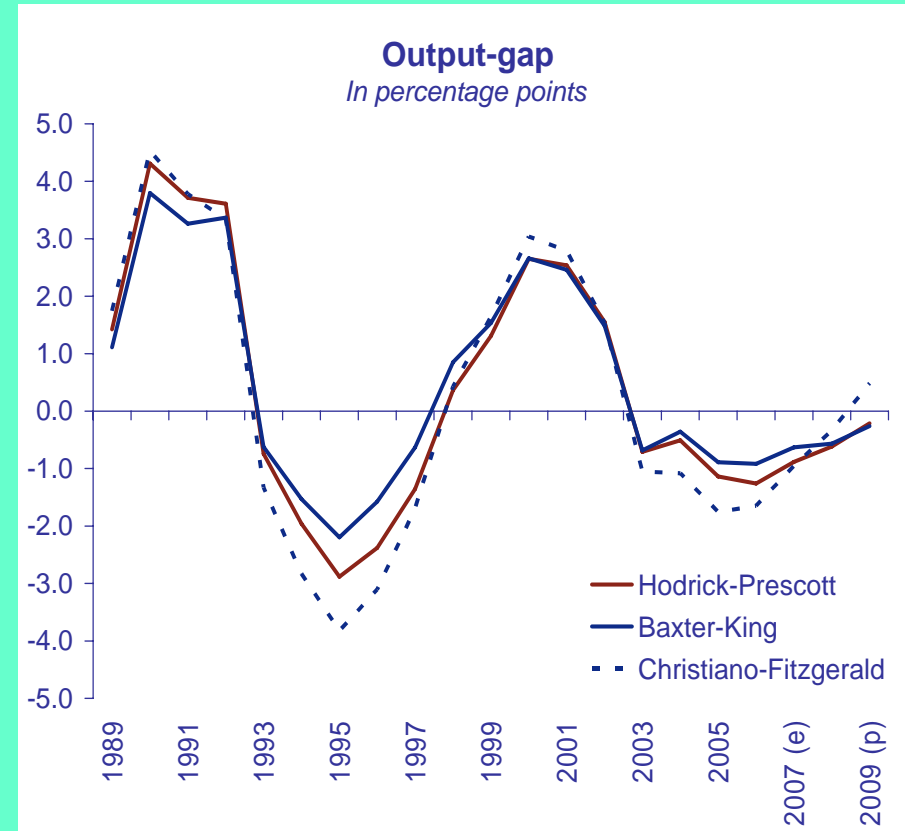
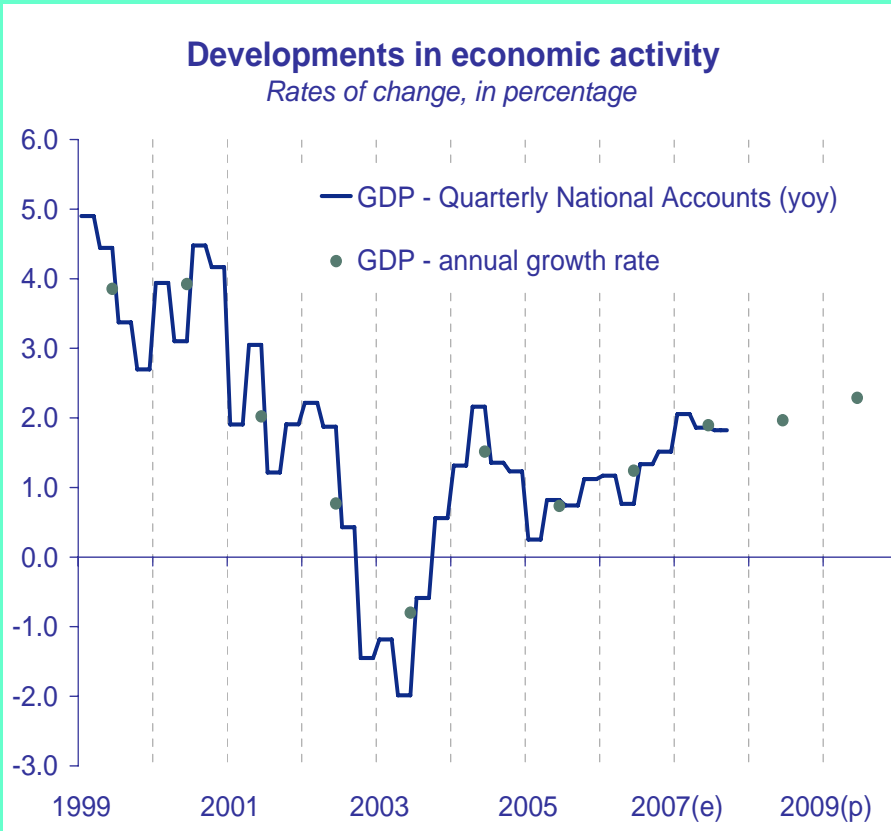
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## Interest rates

Money market interest rates are assumed to ease as of early 2008, as a result of the technical assumption of using financial markets expectations. Risk premium of credit to NFC increased in the second half of 2007. The projection considers a slight increase in the spread between bank lending rates and money market interest rates, throughout the projection horizon.

# Supply

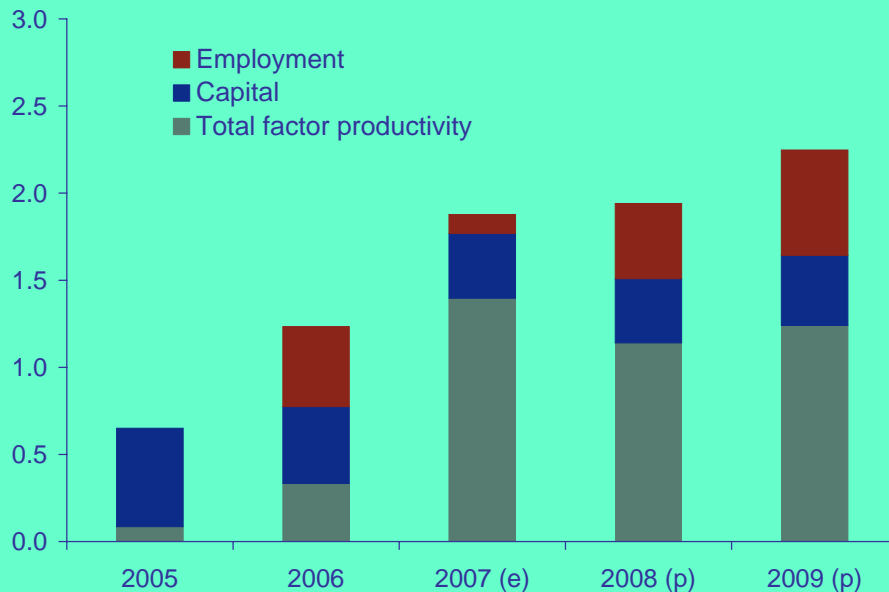
- **Real GDP is projected to accelerate** due to the acceleration in the private sector, since economic activity in the public sector is envisaged to decline marginally.
- **Output-gap gradually narrows**, as real GDP grows above currently available estimates for potential output.



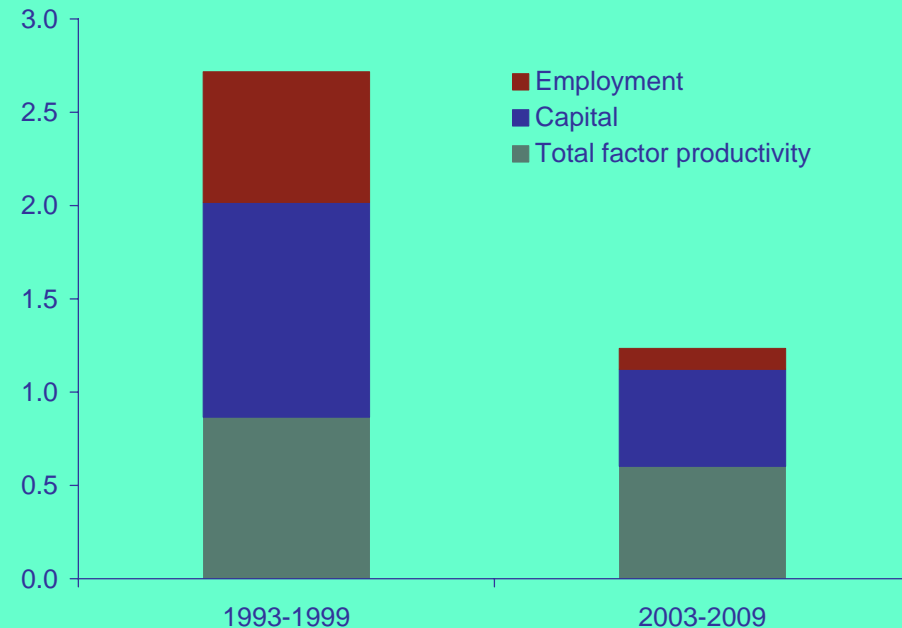
# Supply

- Total factor productivity is expected to play a major role in output growth in 2008 and in 2009, similarly to what happened in 2007.
- The employment contribution is projected to increase, whereas the role of capital is envisaged to remain modest.
- In comparison with the post-1993 recession, the weaker economic growth recorded in the period 2003-2009, reflects chiefly a lower contribution of capital and employment to growth.

**Contribution of inputs to growth**  
*Contribution to growth, in percentage points*



**Comparing contribution of inputs to growth after the 1993 and 2003 recessions**  
*Contribution to growth, in percentage points*

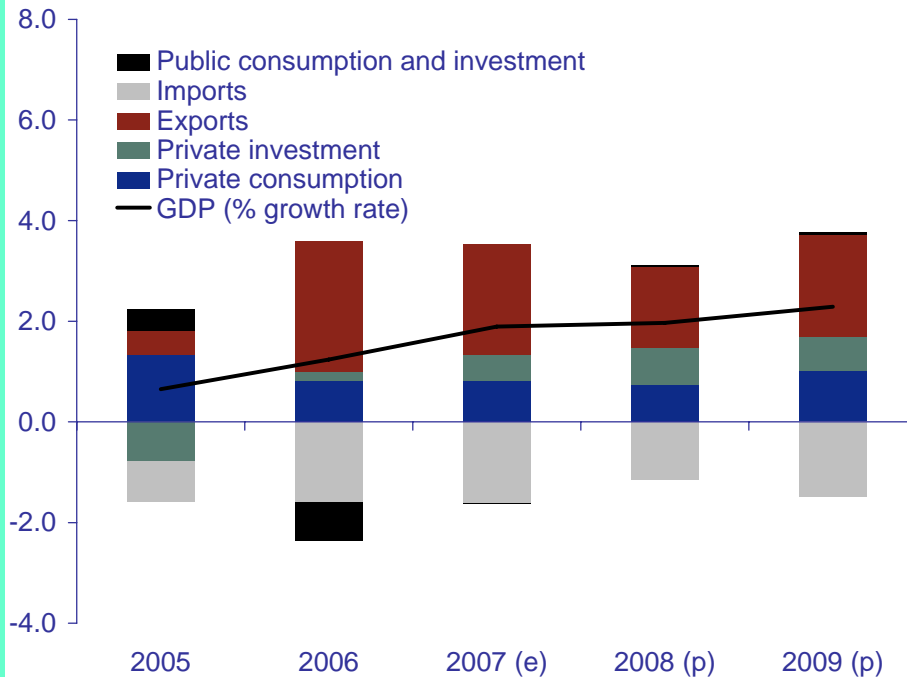


# Demand

- **Domestic demand:** increasing contribution, from 1.3 p.p. in 2007 to 1.8 p.p. in 2009, reflecting the rebound in private investment and consumption.
- Differences between business cycles are chiefly due to domestic demand.

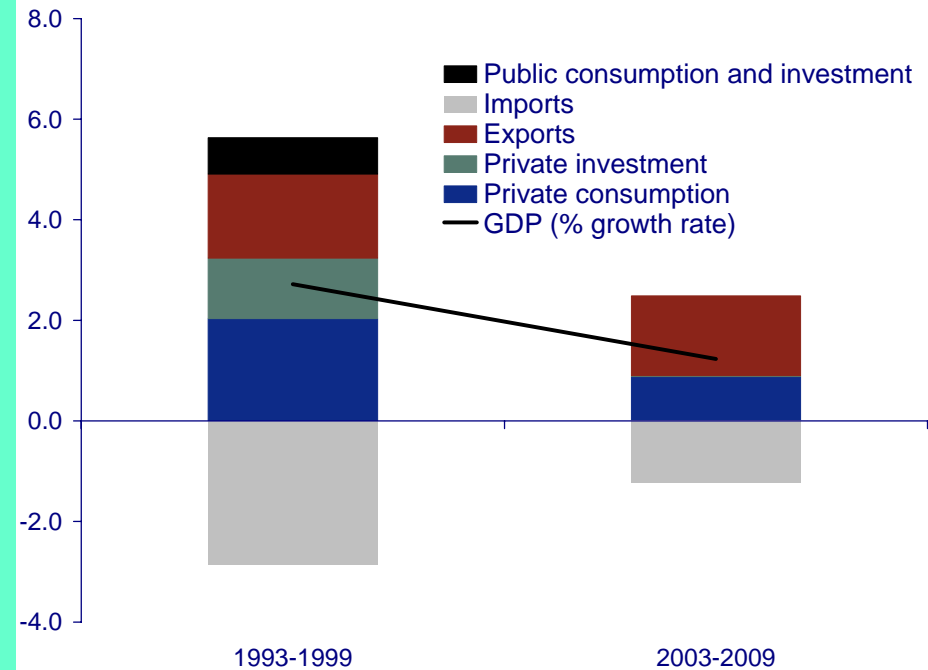
### Breakdown of GDP growth

Contributions to the rate of change in percentage points



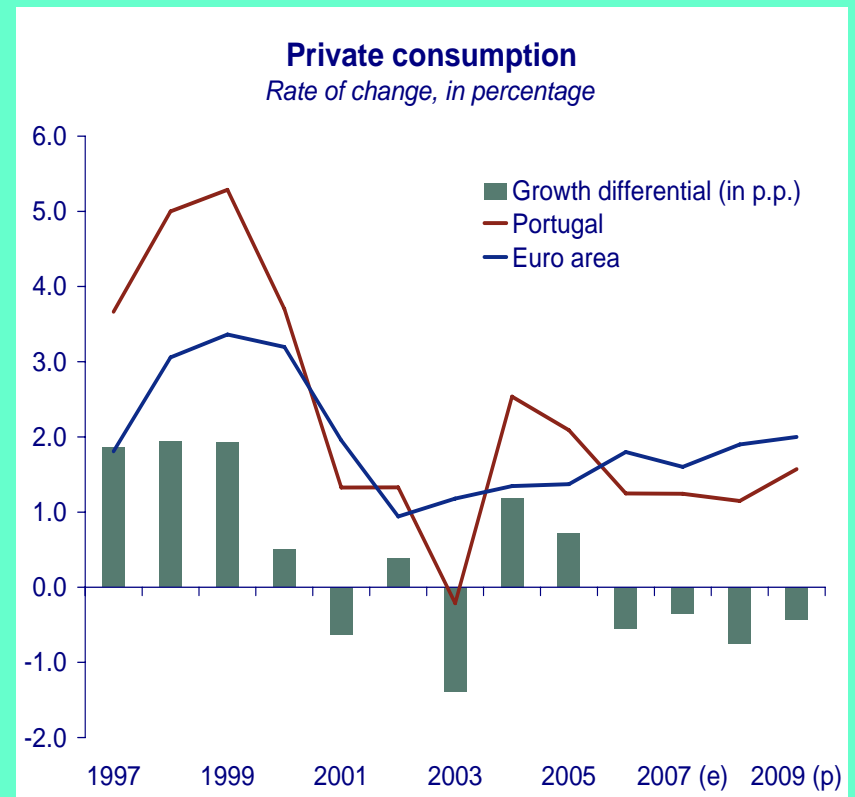
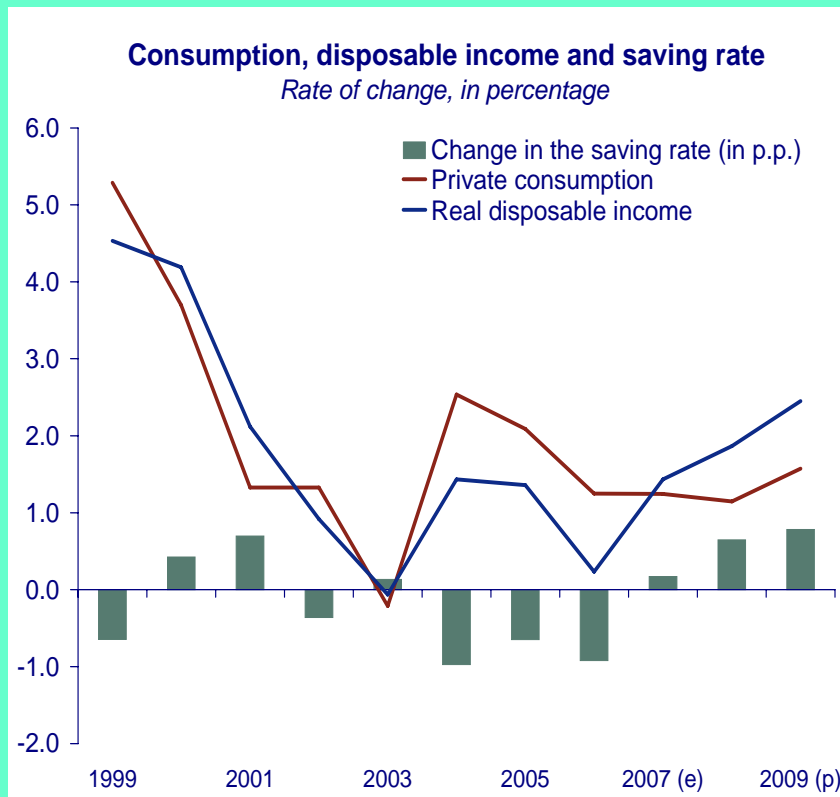
### Breakdown of GDP growth 1993-99 vs 2003-09

Contributions to the rate of change in percentage points

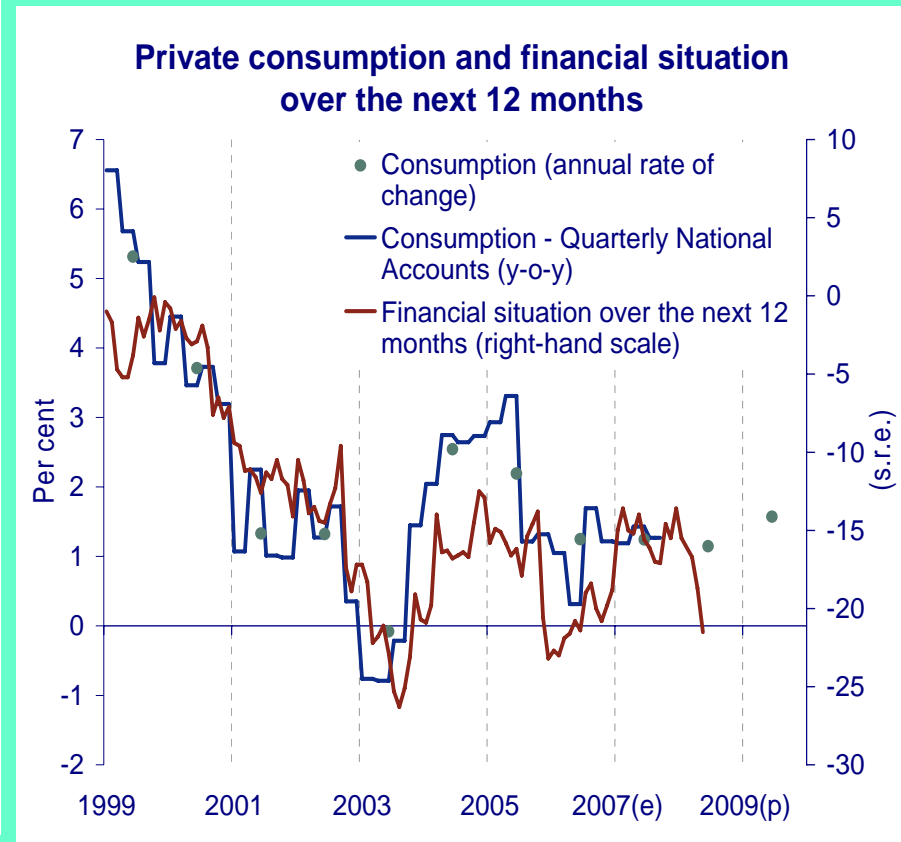
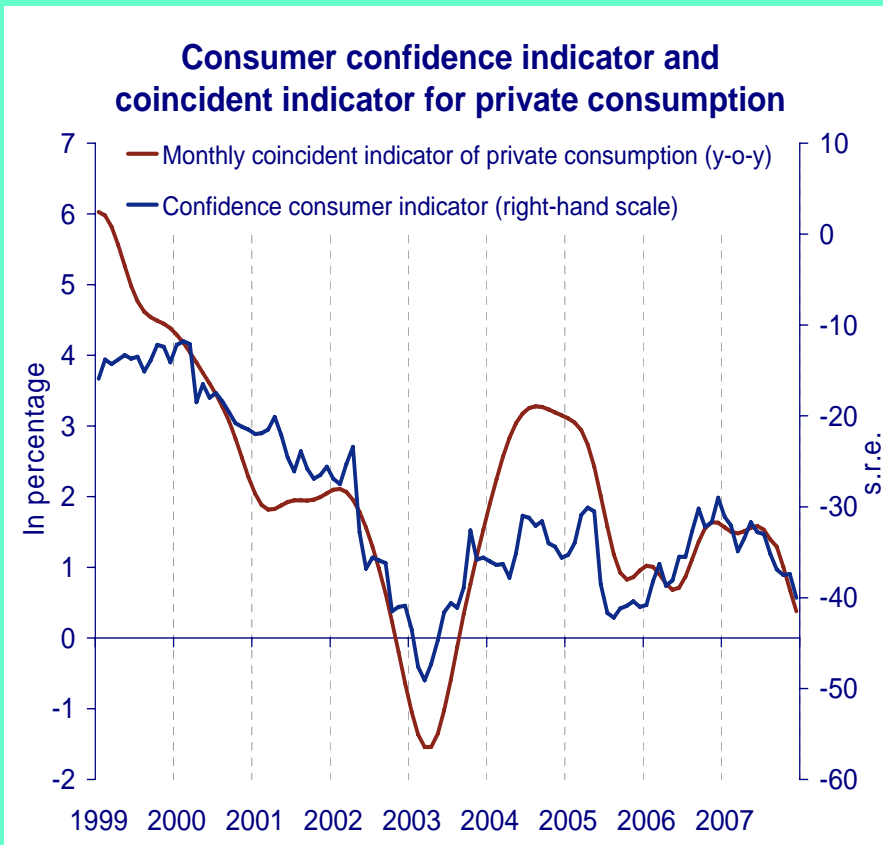


# Private Consumption

- Mild recovery of private consumption, accelerating from 1.2% in 2007 to 1.6% in 2009.
- Private consumption is expected to grow at a slower pace than real disposable income, fostering a recovery in households' saving rate.
- Private consumption growth is expected to remain below that of the euro area.



# Private Consumption



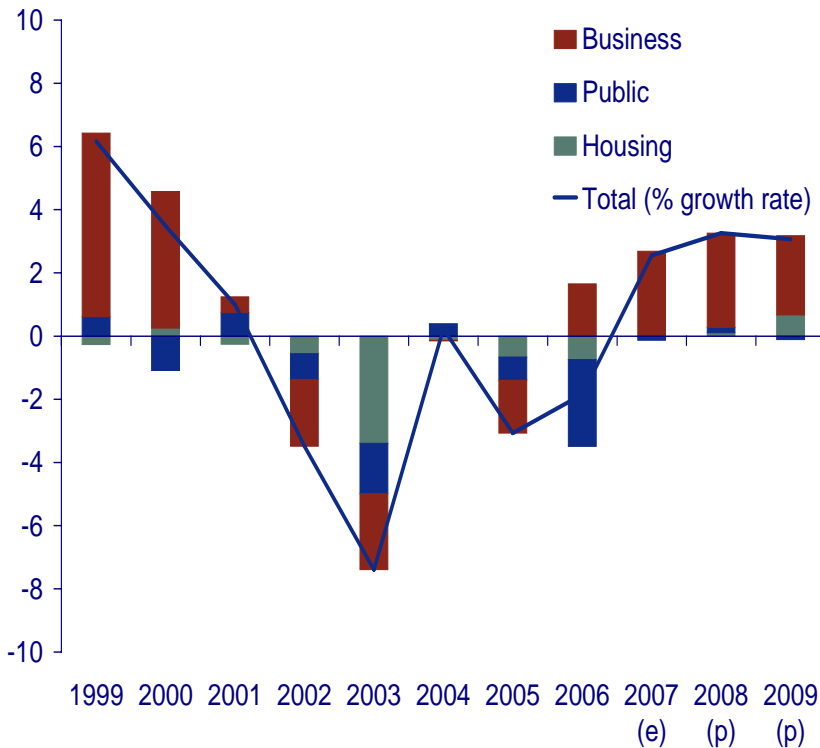
- The Coincident Indicator for consumption and the Consumer Confidence Index continued to fall in November and December.

# Gross Fixed Capital Formation

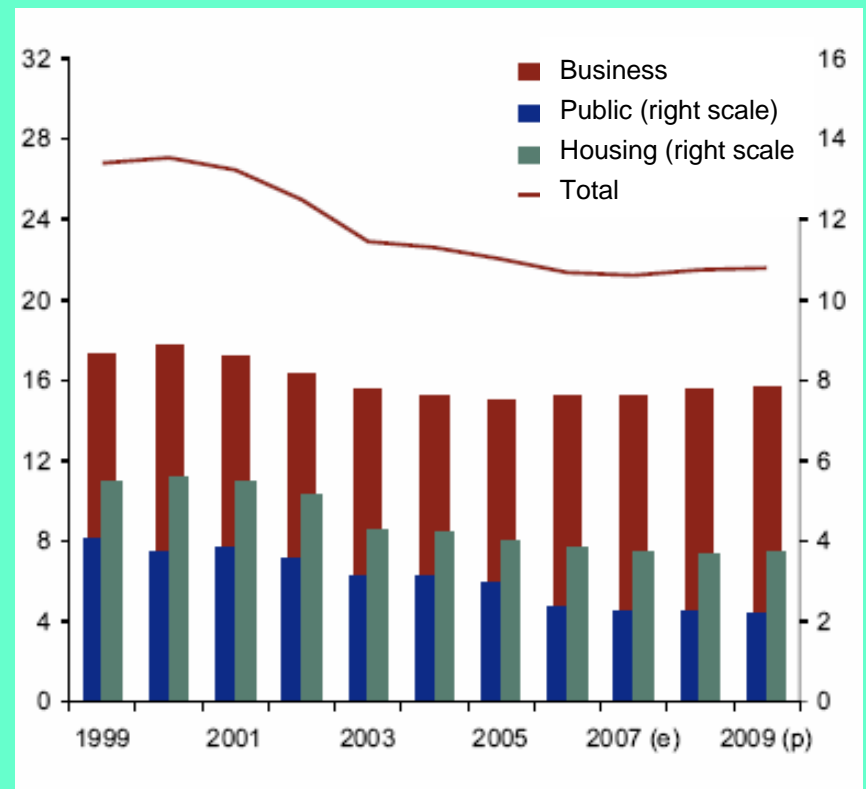
- **Recovery of GFCF from 2.6% in 2007 to 3.1% in 2009.**
  - The **acceleration in GFCF**, reflects the evolution of housing and business investment and the stabilization, in real terms, of public investment.
  - Projected business investment is in line with its empirical relationship with private GDP growth.

## Breakdown of GFCG

Contribution to the rate of change in percentage points

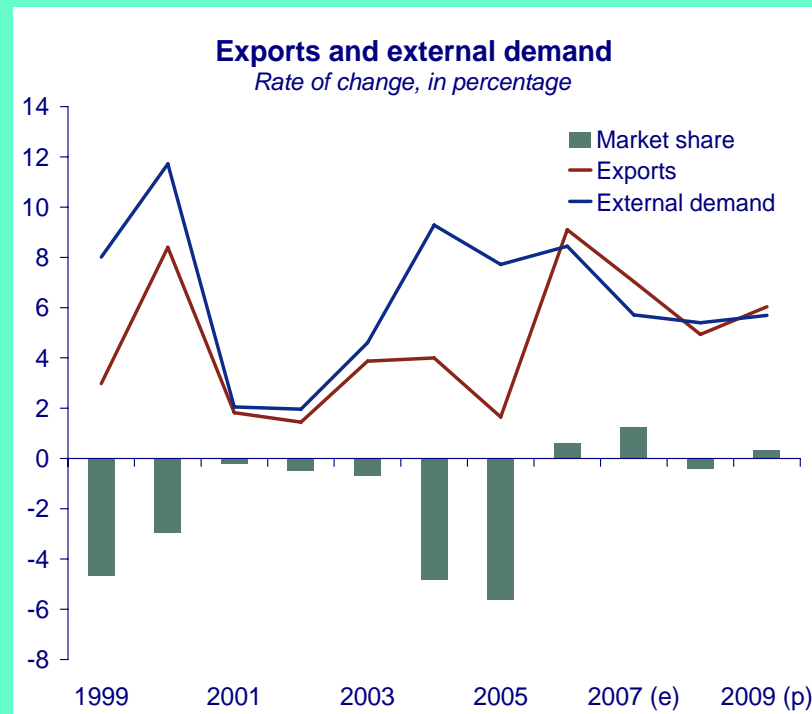


## Investment by institutional sector

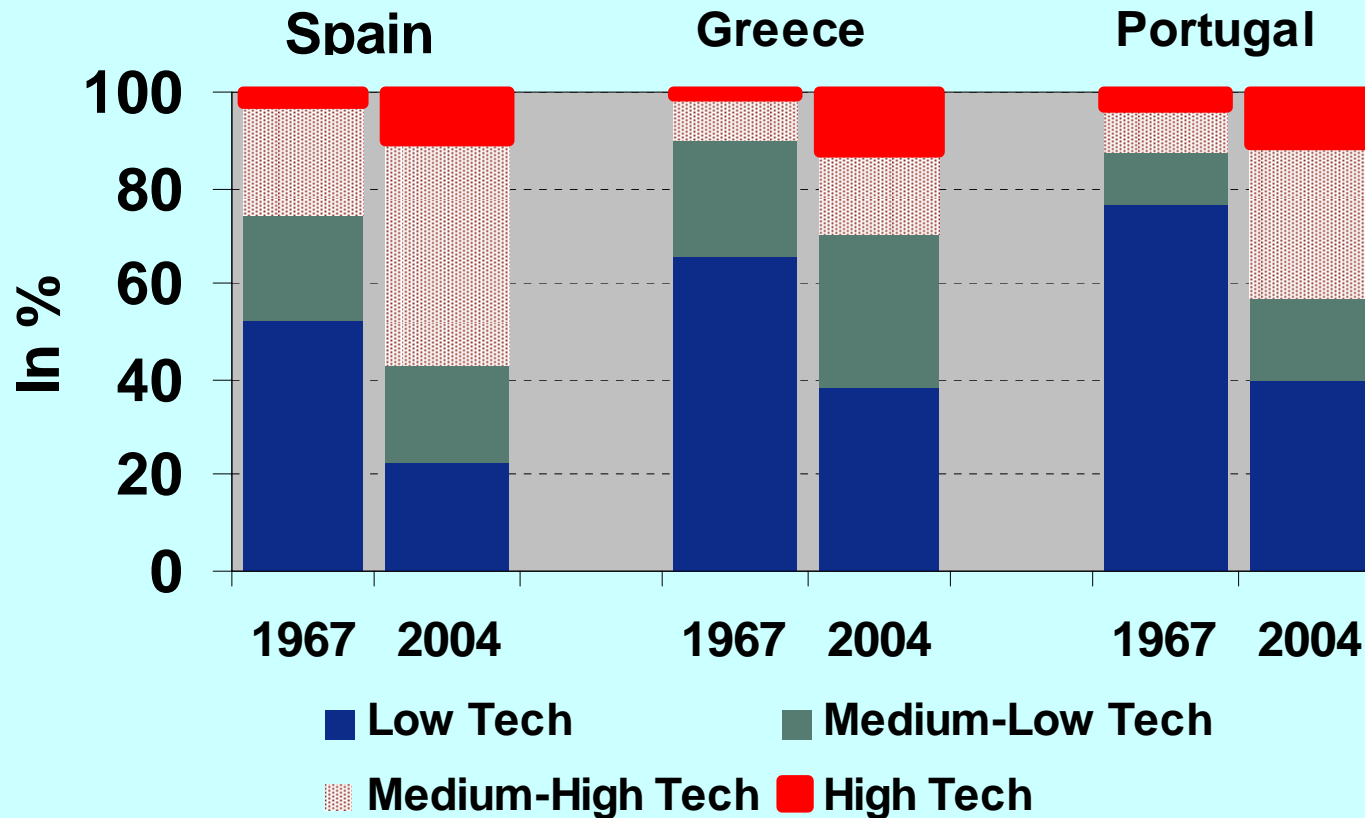


# Exports

- **Exports** are estimated to remain the most dynamic component of demand.
  - A significant deceleration is estimated to have occurred in the second half of 2007, due to the evolution of the goods component, since services exports remained buoyant.
  - Deceleration in 2008 (from 7.0% in 2007 to 4.9%), and acceleration in 2009 (to 6.0%), in line with external demand, implying fairly constant market shares.
  - Projected exports are consistent with the gradual process of restructuring in the manufacturing sector and some reallocation of resources to more technology- and human capital-intensive products.



## Structure of Manufacturing Exports by technological intensity (% of total)

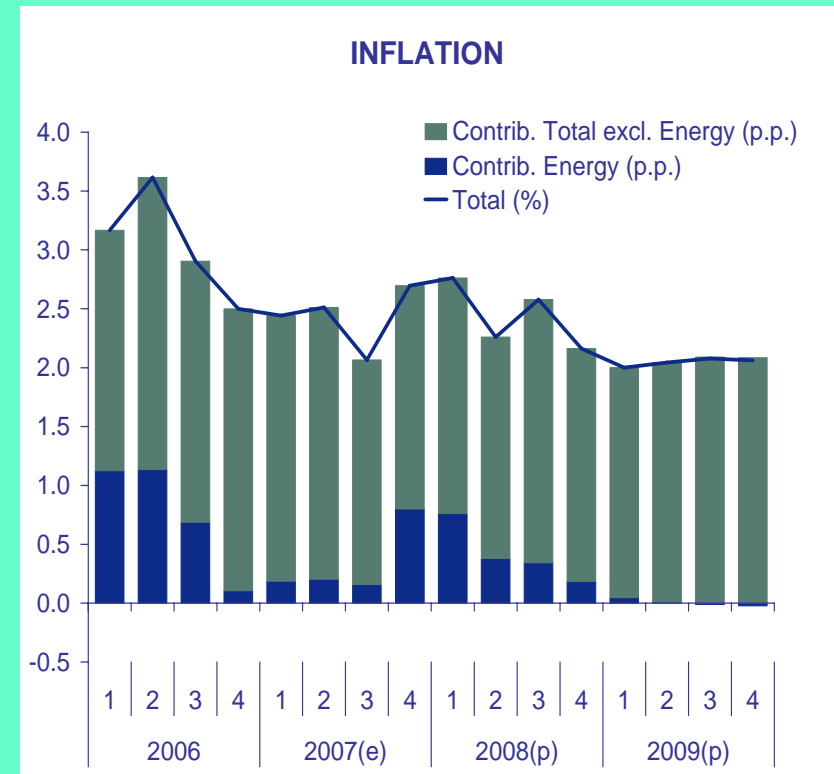
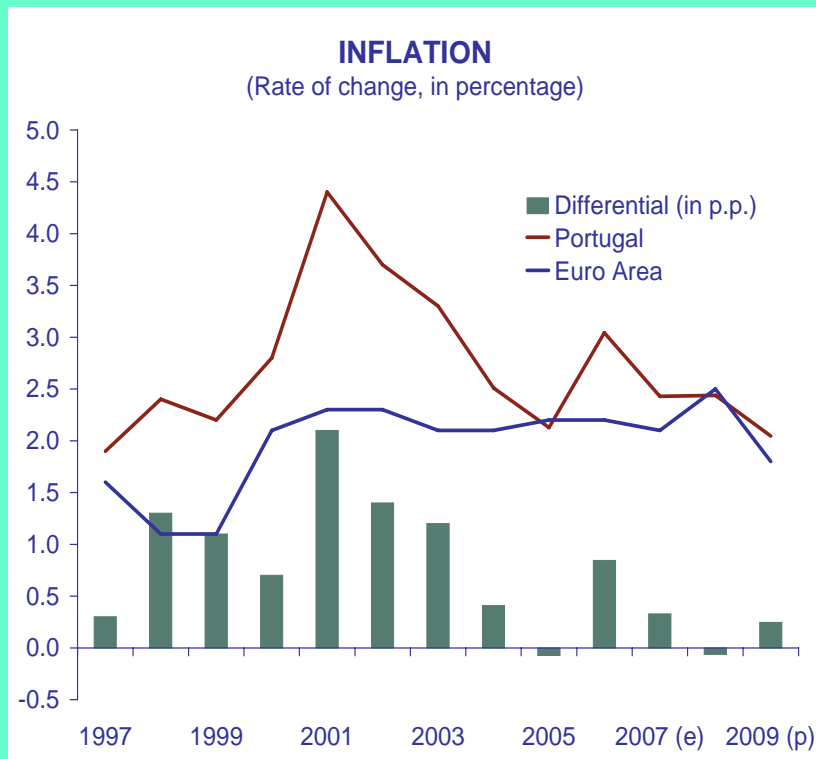


Sources: Chelem database and calculations by Banco de Portugal.  
 Note: The aggregation of industries by technological intensity follows the OECD methodology. See 'OECD Science, Technology and Industry

<b>2006: Exports of goods and services</b>	<b>100%</b>
<b>Exports of goods</b>	<b>71%</b>
Of which: Machines and equipment	14,1%
Metal products	5.9%
Vehicles and transportation equipment	9.4%
Plastics	3.7%
Paper and paper pulp	3.2%
Food products	3.0%
Chemicals	3.6%
Wood and cork products	3.0%
Textiles	3.4%
Footwear	2.7%
Cloth	5.1%
<b>Exports of services</b>	<b>29%</b>
Of which: turism	13.7%
Transportation services	6.5%
Services to firms	5.1%

# Inflation prospects

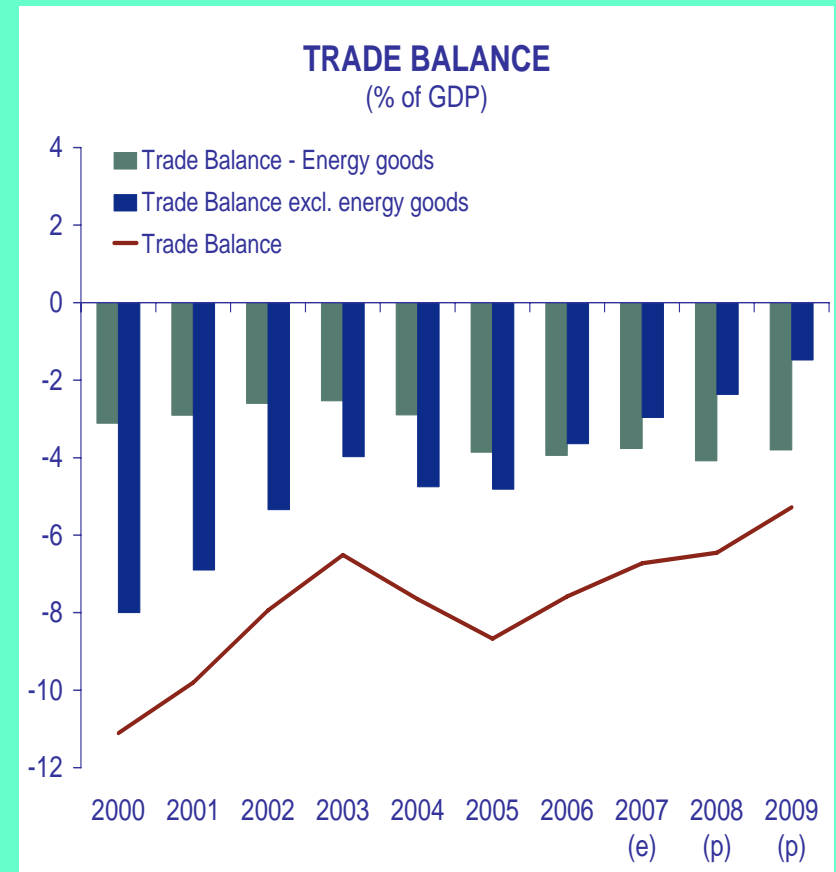
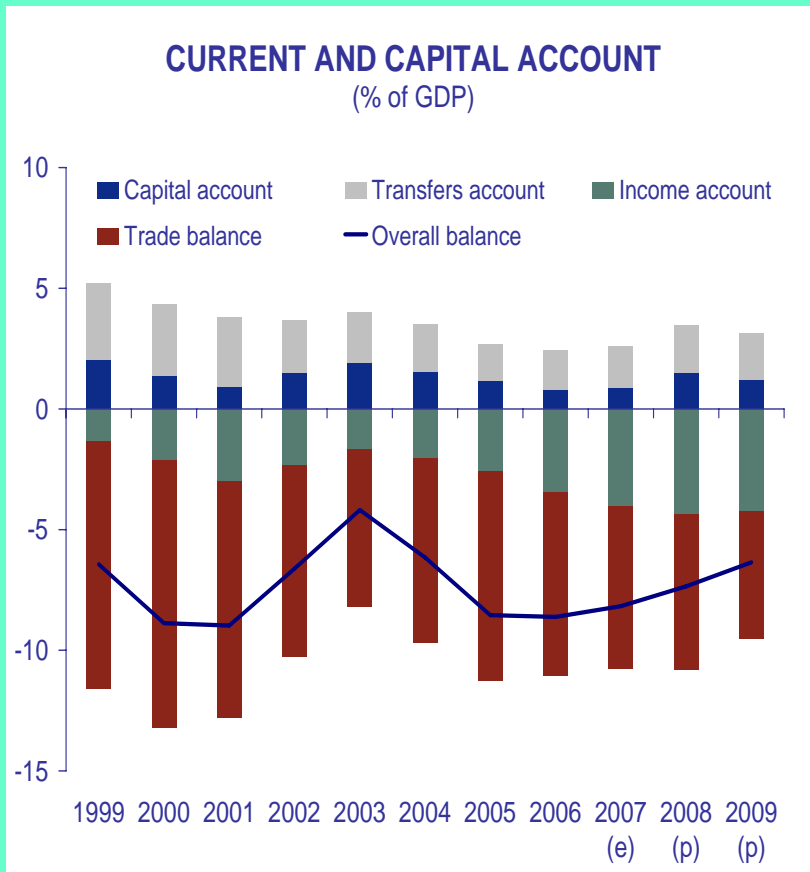
- **Inflation is projected to decline from 2.4% in 2007 and 2008 to 2% in 2009**
  - In 2008, consumer prices are temporarily affected by the impact of food commodities and oil prices.
  - The deceleration to close to 2% in 2009 stems essentially from the evolution in the energy component, which is assumed to follow futures' markets.
- **HICP inflation is projected to remain relatively close to the euro area.**



# Current and capital account

External financing requirements are projected to decrease 1.8 p.p. of GDP between 2007 and 2009

- **Trade balance deficit declines** in a context of moderate domestic demand growth.



# Uncertainty and risks to the projection

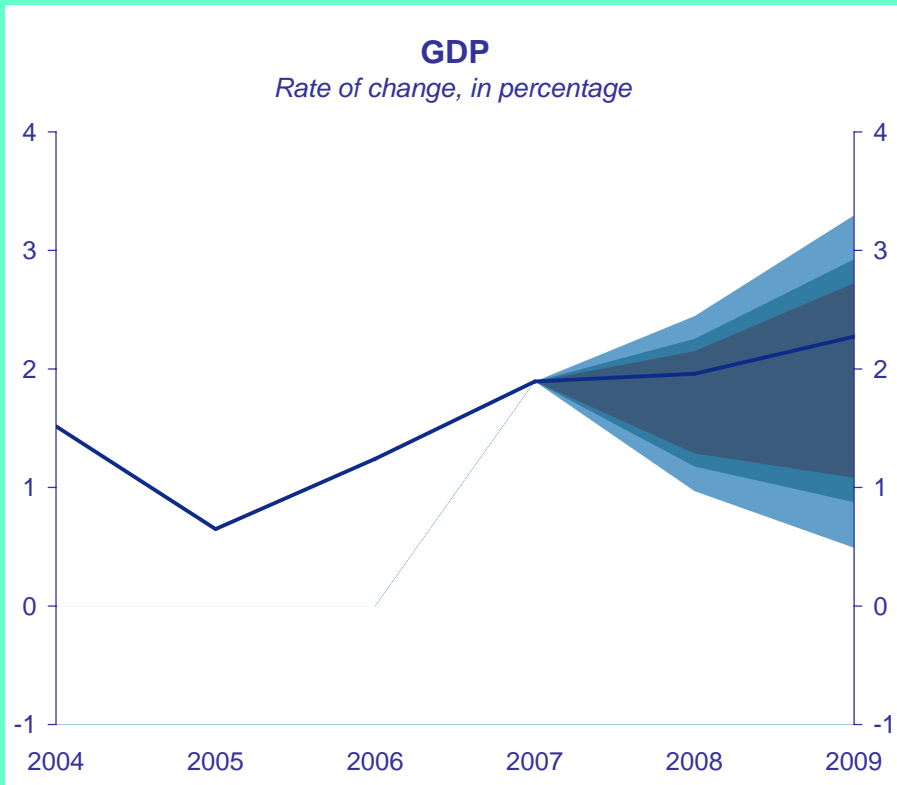
- **Higher than usual uncertainty and downward risks** for economic activity reflecting:
  - Increased turbulence in international financial markets;
  - The possibility of a stronger than currently envisaged slowdown in US economy, in a context of still prevailing global macroeconomic imbalances;
  - The estimated deceleration of exports in the second half of 2007 may imply market share losses, which might be more persistent than projected.

## **As a result:**

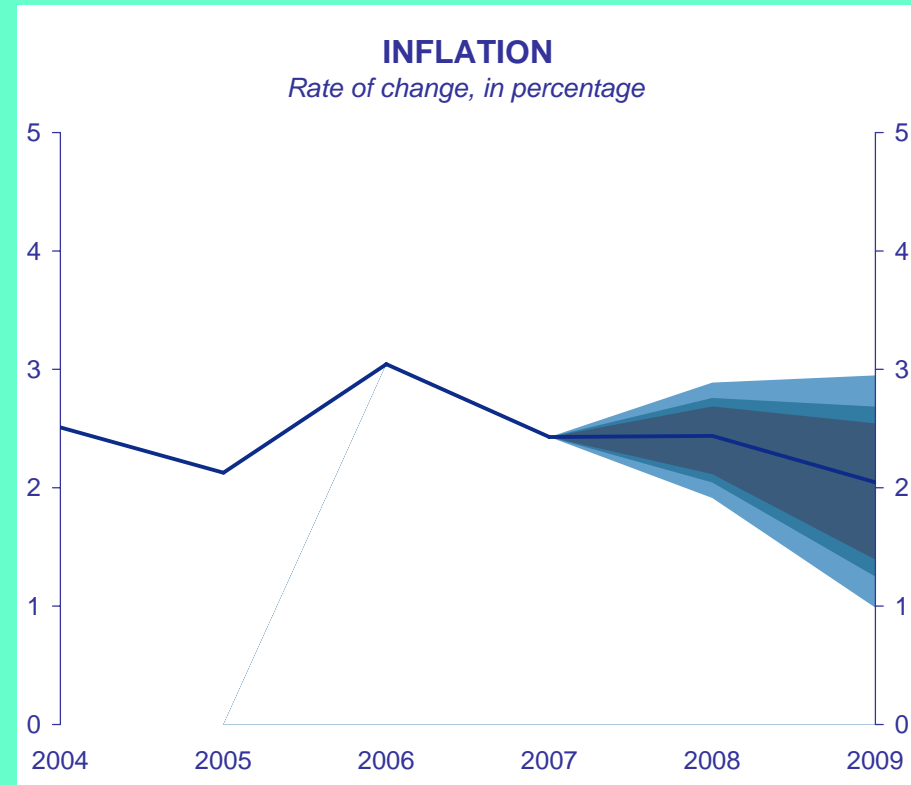
- The **external demand** may be lower than assumed, the **interest rate** may be higher and the **euro exchange rate** may appreciate more than in the central scenario;
- **Private consumption, GFCF** and **exports** may be directly affected on the downside.

# Uncertainty and risks to the projection

The balance of risks for **economic activity** is clearly on the **downside**



The balance of risks for **inflation** is slightly on the **downside**.



- **Macroeconomic outlook**
- **Consolidation of Public Finance**
- **Banking and Financial Stability issues**

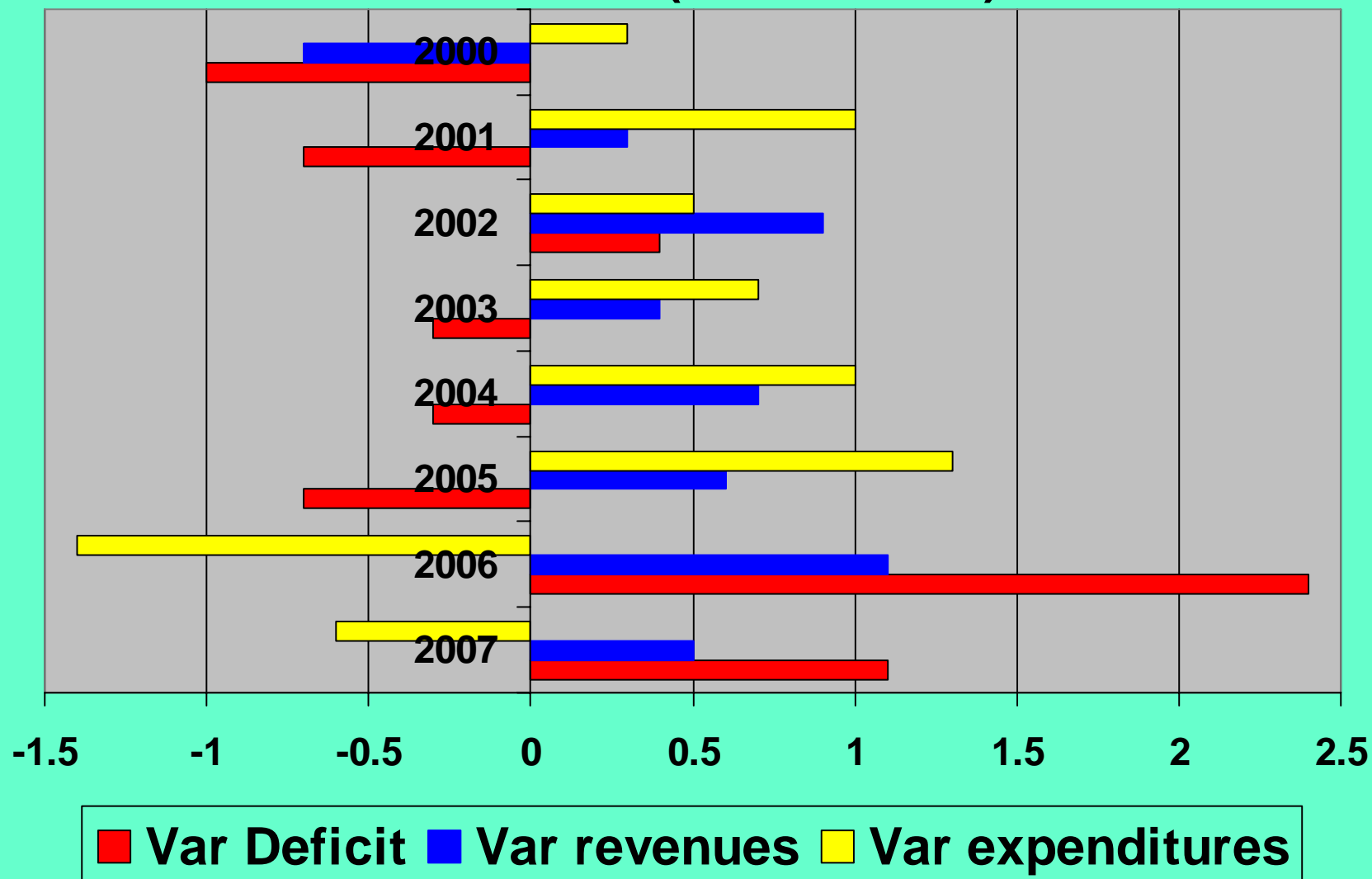
# PUBLIC FINANCE

<b>(In % of GDP)</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b>Total Nominal Deficit</b>	<b>-3.4</b>	<b>-6.1</b>	<b>-3.9</b>	<b>-3.0</b>
<b>Total Structural Deficit (a)</b>	<b>-5.1</b>	<b>-5.7</b>	<b>-3.5</b>	<b>-2.4</b>
<b>Primary deficit</b>	<b>-0.7</b>	<b>-3.5</b>	<b>-1.1</b>	<b>-0.1</b>
<b>Structural Primary Deficit(a)</b>	<b>-2.5</b>	<b>-3.1</b>	<b>-0.7</b>	<b>0.5</b>
<b>Public Debt ratio</b>	<b>58.3</b>	<b>63.7</b>	<b>64.8</b>	<b>64.4</b>

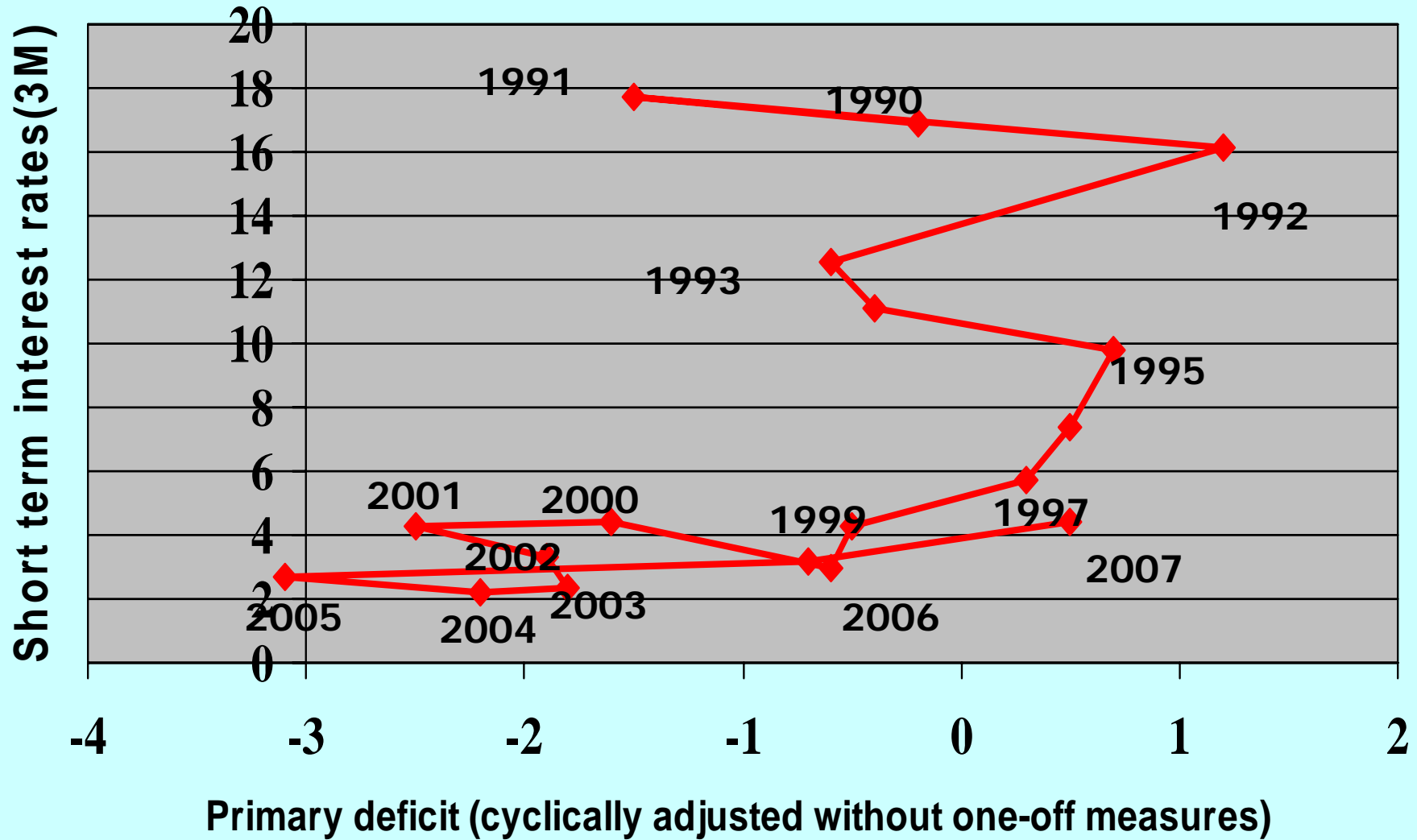
(a): cyclically adjusted and without one-off measures

Sources: INE, Ministry of Finance and Banco de Portugal. Quarterly Economic Bulletin, Autumn 2007

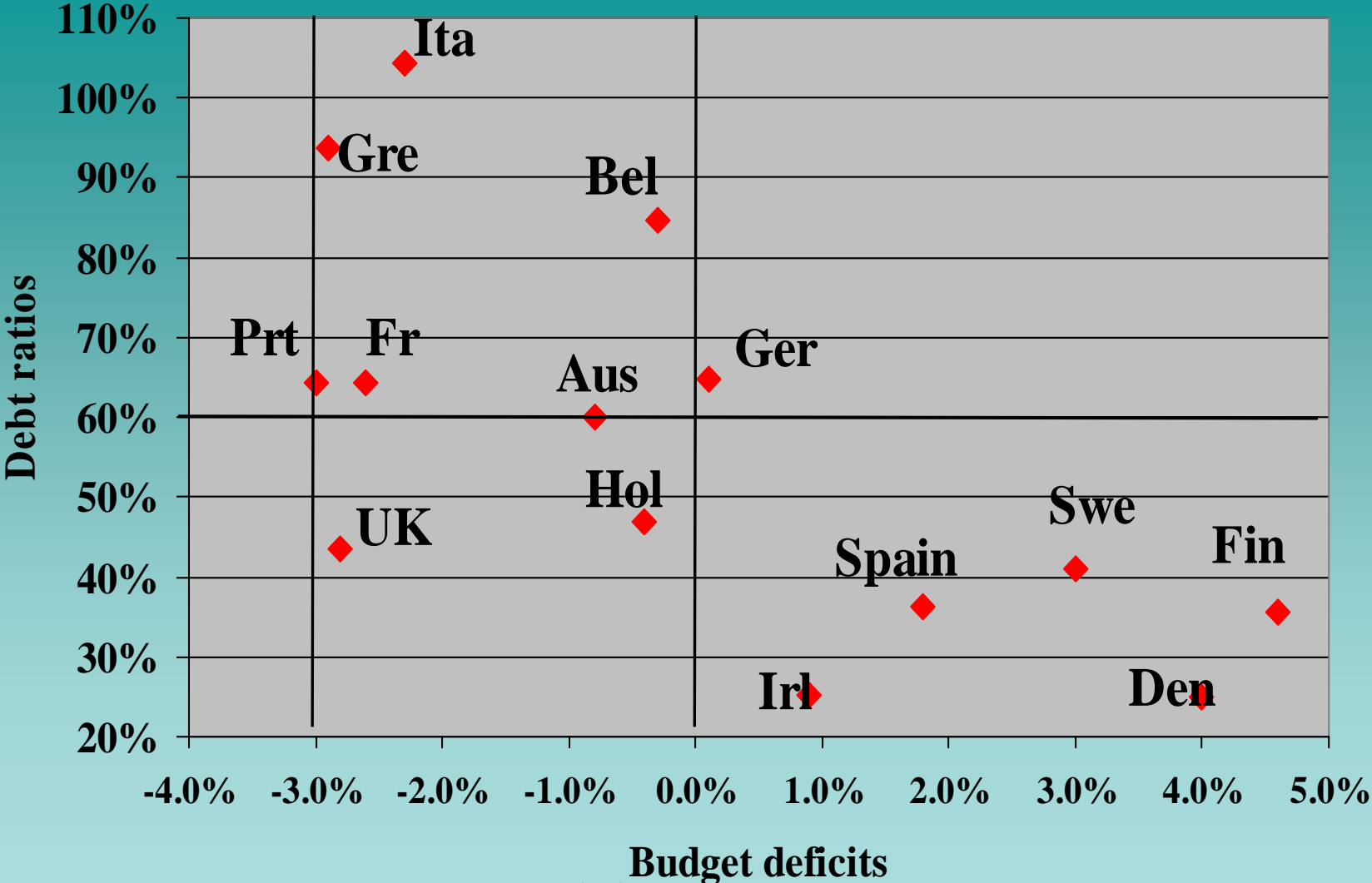
# Variation of primary deficits, revenues and expenditures, cyclically adjusted and without one-off measures (in % of GDP)



# Macroeconomic policy



# Budget deficits and Debt ratios in 2007



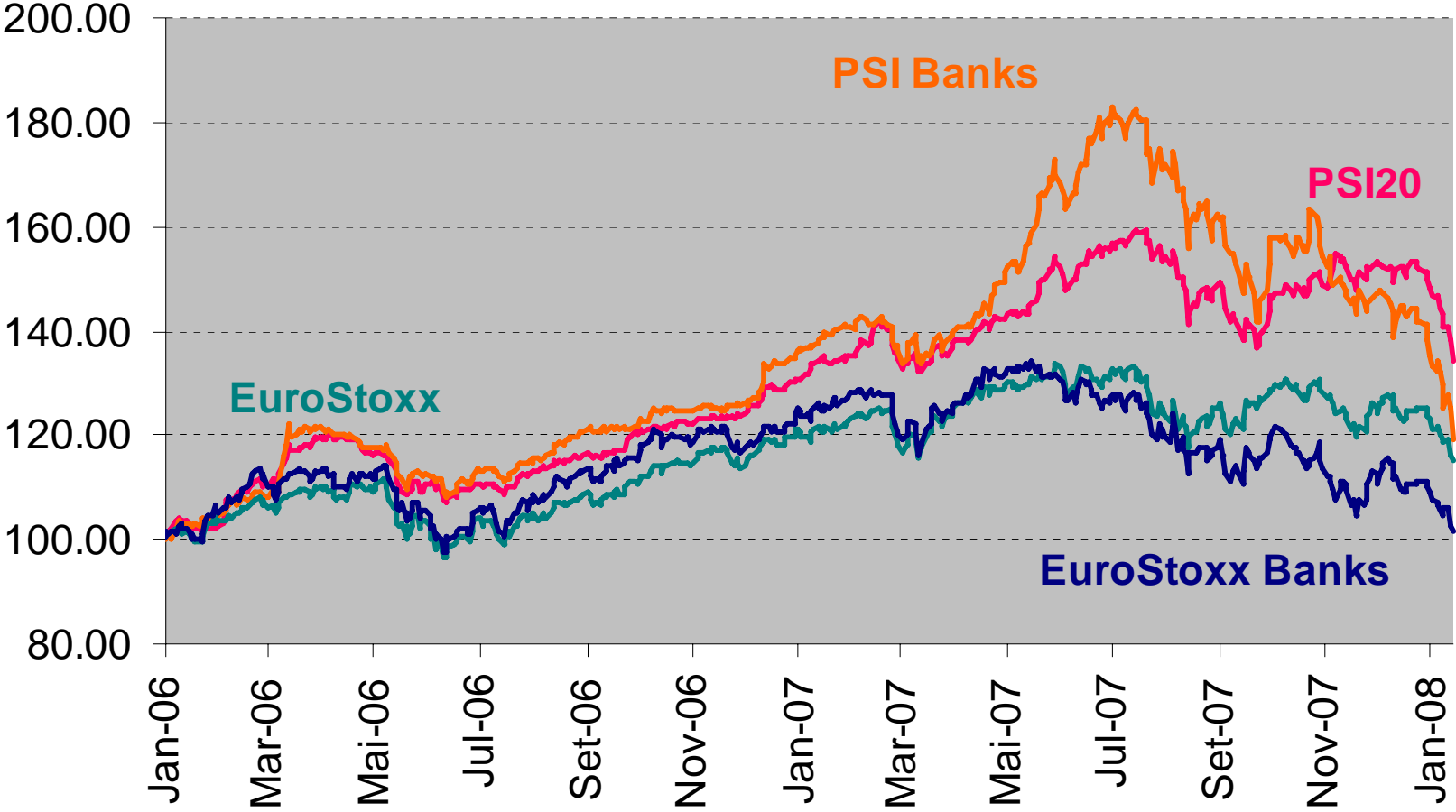
Source: Autumn Forecasts 2007, E.Commission

- **Macroeconomic outlook**
- **Consolidation of Public Finance**
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## Banking Sector Indicators

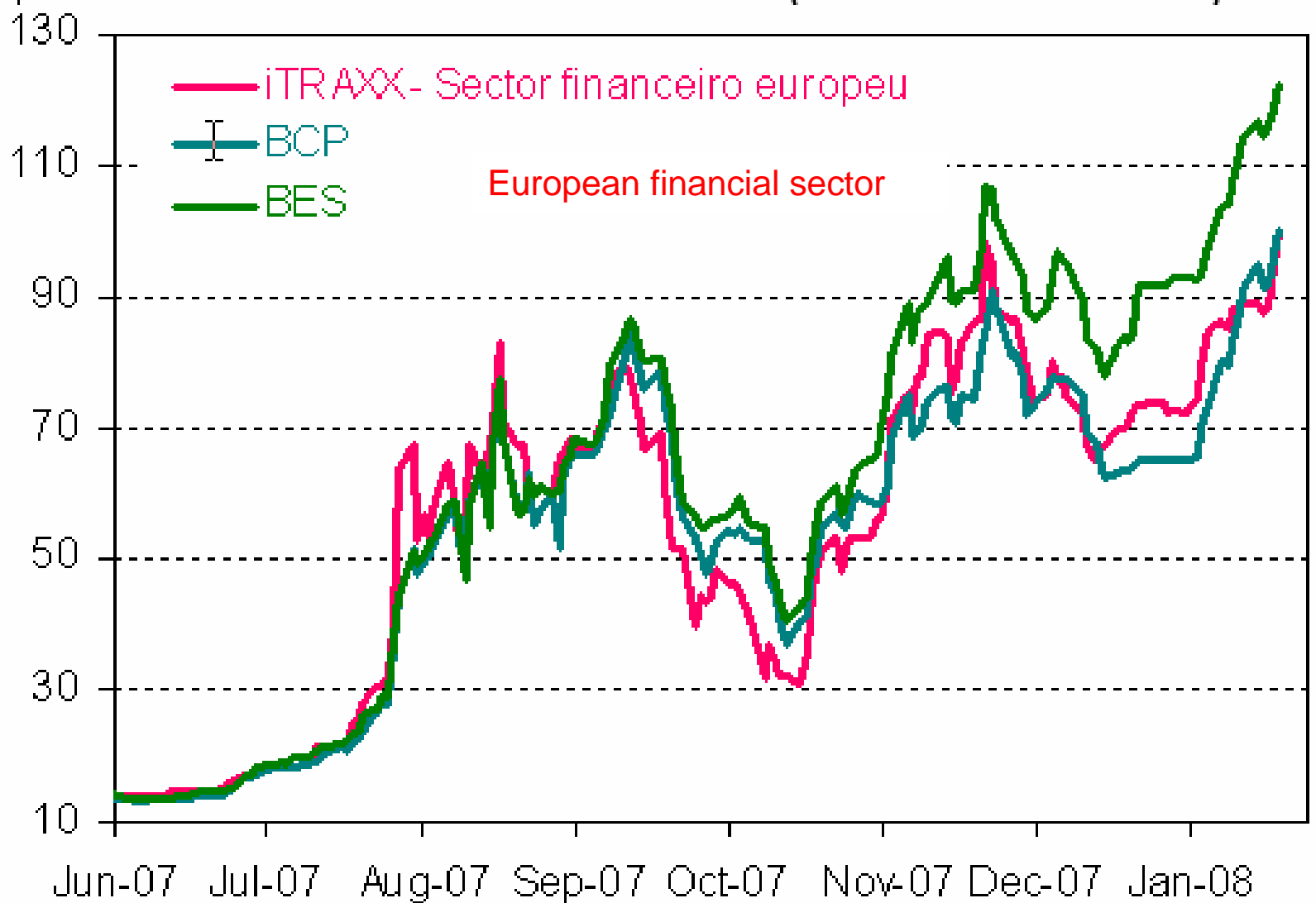
	Jun 2006	Dez 2006	Jun 2007
<b>Capital Ratio</b>	11,5%	10,9%	10,2 % (P)
<b>Non performing loans (% of total credit)</b>	1,44%	1,28%	1,29%
<b>Net interest margin (% of Assets)</b>	1,87%	1,89%	1,92%
<b>Other revenues (Fees and Commissions, trading etc) in % of Assets</b>	1,63%	1,55%	1,52%
<b>Cost – Income ratio</b>	51,7% (55,0%)	53,5% (55,1%)	48,8%
<b>Return on Assets (ROA)</b>	1,44% (1,20%)	1,30% (1,18%)	1,36%
<b>Return on Capital (ROE)</b>	23,6 (19,8%)	20,6% (18,9%)	20,6%

# Stock Markets - Portuguese and European



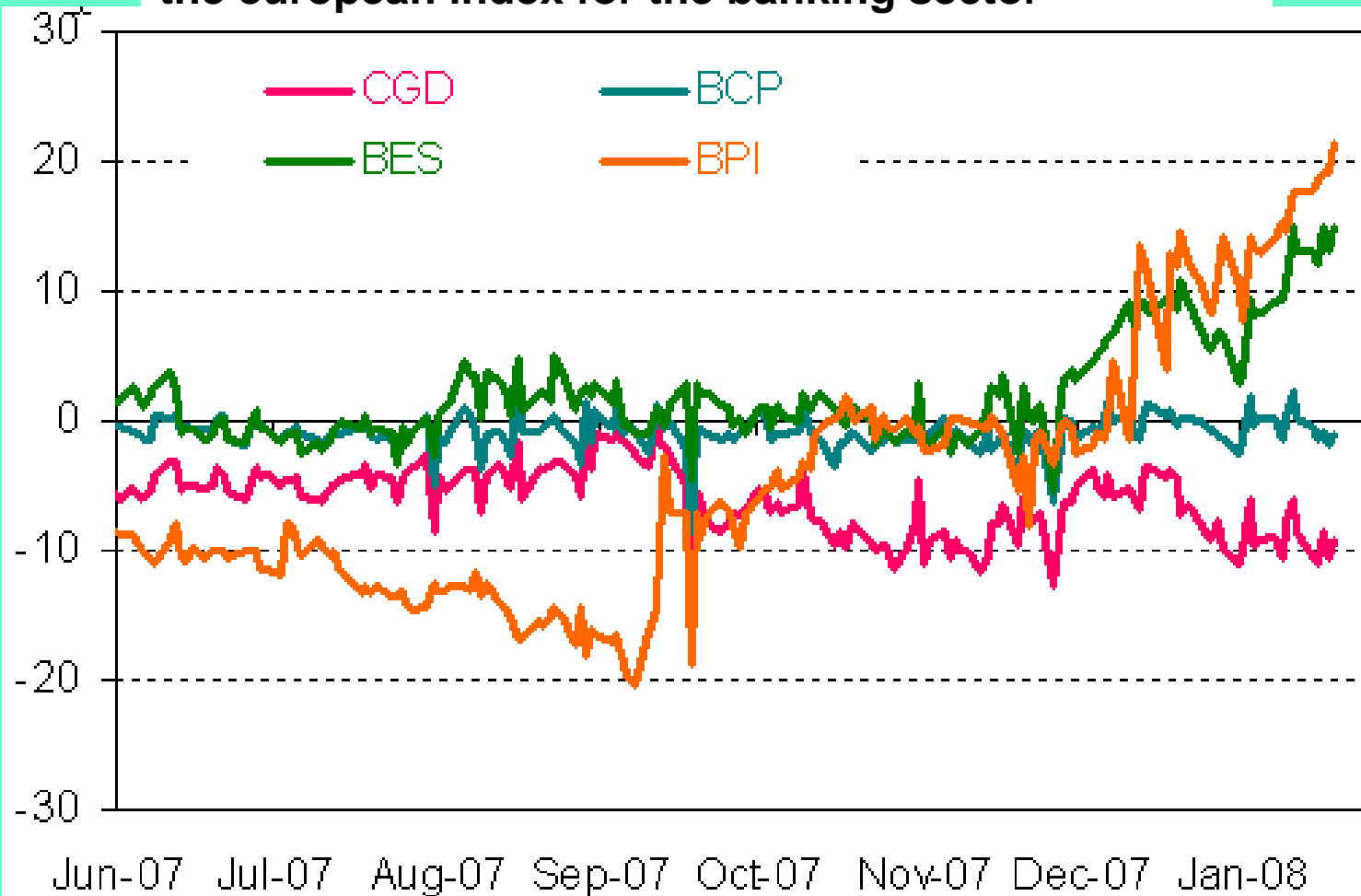


# Premium of 5 years CDS (subordinated debt)



Data on 21st Jan 08

## Spreads of bonds issued by Portuguese Banks over the european index for the banking sector



Data on 21st Jan 08

# FITCH's Banking Systemic Risk Report (Sept 2007)

	Macro-prudential Indicator			
Categories of Banking Risk	1	2	3	Nº of Countries
<b>A</b>		UK US Hol Spain Lux, Swiss.	Australia	<b>7</b>
<b>B</b>	Austria, Chile, Germany, Japan....	Belgium, <u>Portugal</u> , France, Finland, Greece, Sweden, Denmark ...(in a total of 18 countries)	Canada Korea, Iceland, South Africa	<b>30</b>
<b>C</b>	Cyprus Malasia ...	Brasil, Latvia Malta Slovenia...		<b>9</b>
<b>D</b>	China Hungary Poland...	Bulgaria India Romenia Venezuela TurKey Ukrane...	Russia	<b>28</b>
<b>E</b>	Argentina Bolívia ...	Armenia		<b>13</b>
<b>Nº of Countries</b>	<b>34</b>	<b>45</b>	<b>8</b>	<b>87</b>

Source: FITCH « Bank Systemic Risk Report», September 2007

- **IMF Public Information Notice (PIN) No. 07/126**
- **October 11, 2007**

**«Portugal's financial system remains sound and well supervised and appears to have weathered the recent tensions in financial markets relatively well, though risks remain. While intensified competition has resulted in a slight deterioration in banks' liquidity ratios, average loan-to-value ratios are in line with other EU countries, and nonperforming loans remain low. High household and corporate debt remains the main source of risk to the financial system, but the Financial Sector Assessment Program (FSAP) exercise last year found that the financial system could withstand even severe macroeconomic disturbances. »**

# CONCLUSIONS

- After an estimated increase of 1.9% in 2007, real GDP is projected to grow 2.0% in 2008 and 2.3% in 2009, which is relatively close to the euro area projections.
- The **inflation rate** is projected to decrease to 2.0% in 2009 (2.4% in 2007 and 2008).
- The **uncertainty and risks** of the current projection are **unusually high**, difficult to quantify and associated, in particular, to international developments.
- The **correction of the economic imbalances** is expected to continue. A special focus should be placed on...
  - ...the ongoing fiscal consolidation process;
  - ...the improvement of the external financing requirements of the economy.
- The **Banking sector** continued to show resilience to the recent turmoil, did not register any losses directly associated with it , but in common with other european banks is facing the problems stemming from the liquidity situation in different market segments