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# The economy and the banking sector: recent developments



*Banco de Portugal*

**VÍTOR CONSTÂNCIO**

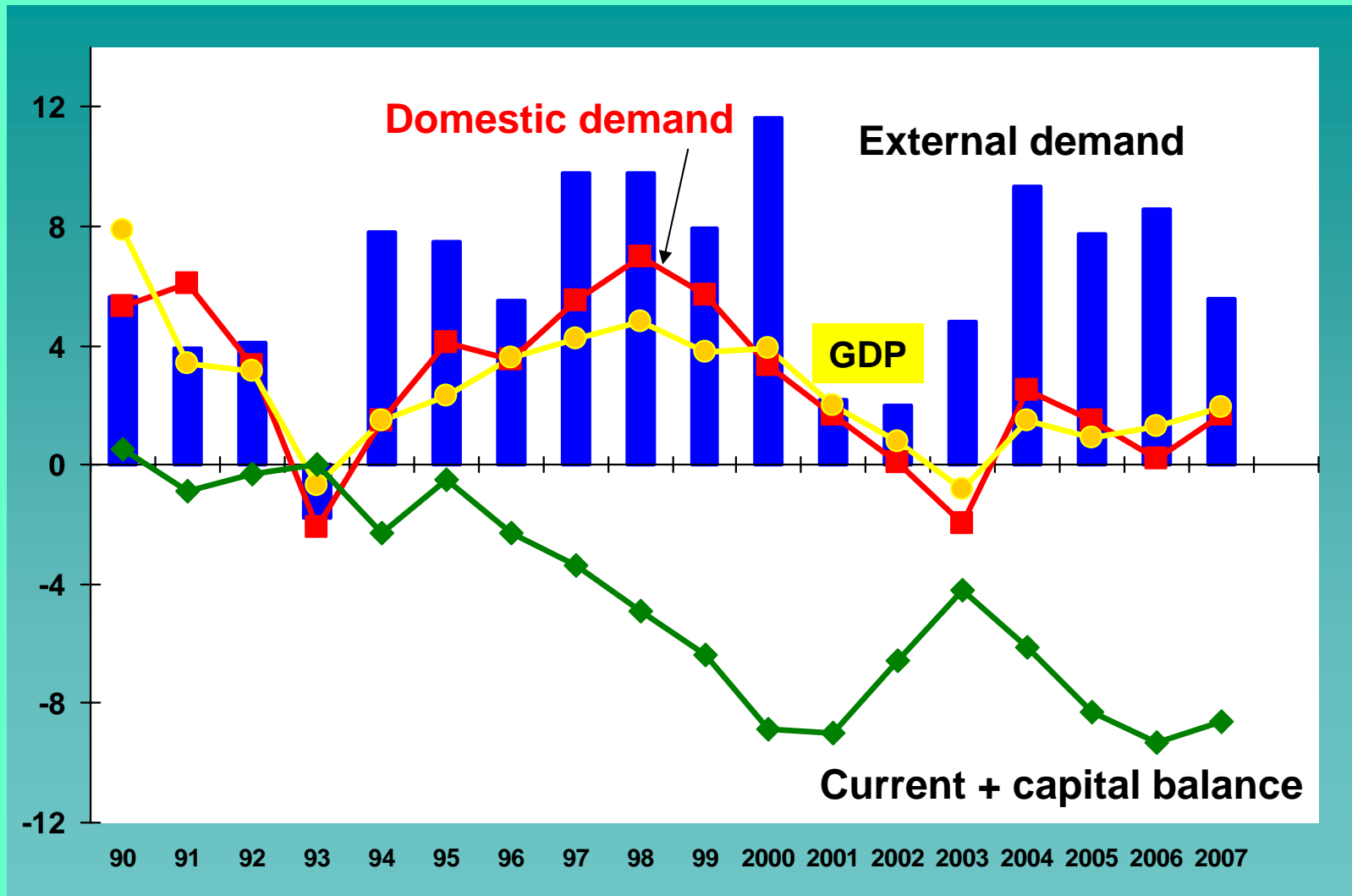
**The Economist Business  
Roundtable, Lisbon 20 January 2009**

- **Portugal in the euro: from boom to adjustment**
- **Short-term macroeconomic outlook**
- **Banking and Financial Stability issues**

# The Portuguese experience in the euro area

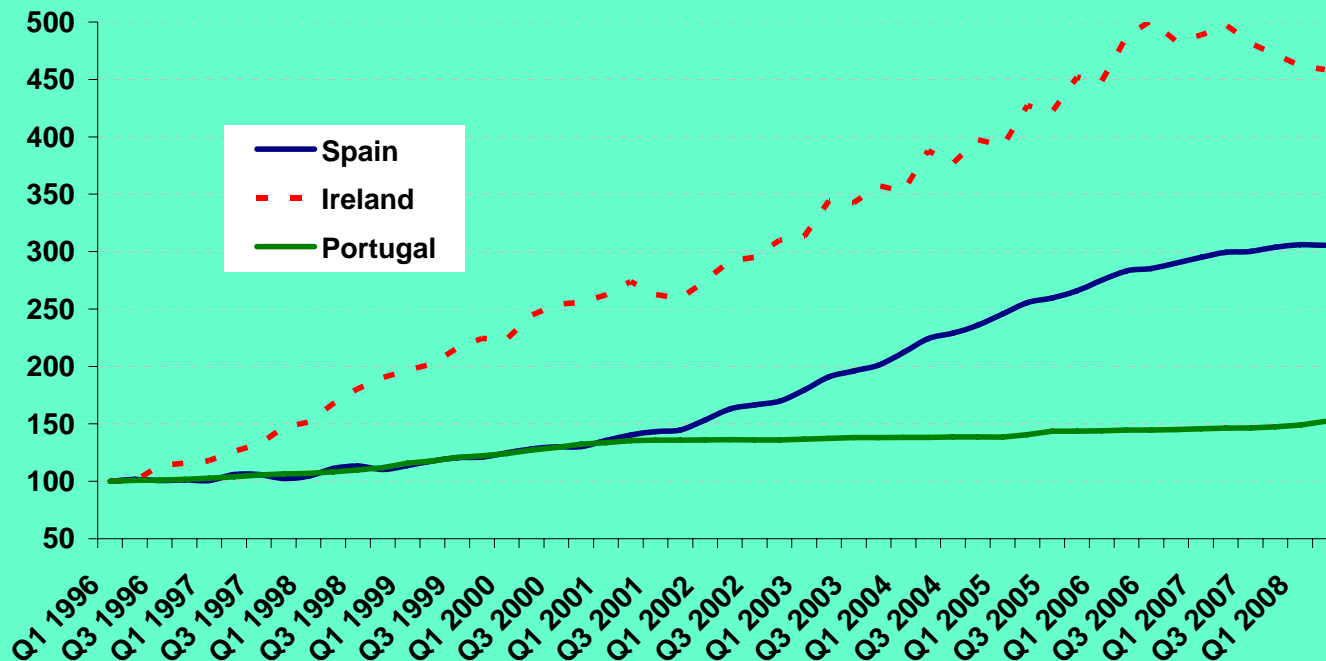
- Portugal is a good example of the challenges faced by a country joining coming from a previous high inflation regime.
- In fact, many of the incentive structures and mechanisms underlying the functioning of a monetary union can be observed in the Portuguese adjustment experience since 1995.
- The behaviour of the Portuguese economy in the past decade is a story of transition to a new regime of lower inflation and of adjustment to the rules of the game in a monetary union. After an initial boom came a marked slowdown

- Portuguese economy: from boom to recession and adjustment with slow recovery (until the recent turmoil...)



- Features worth noting of the boom period:
  - The boom was relatively short
  - No bubble emerged in the property market
  - Fiscal policy was pro-cyclical
  - The interest rate channel played a significant role

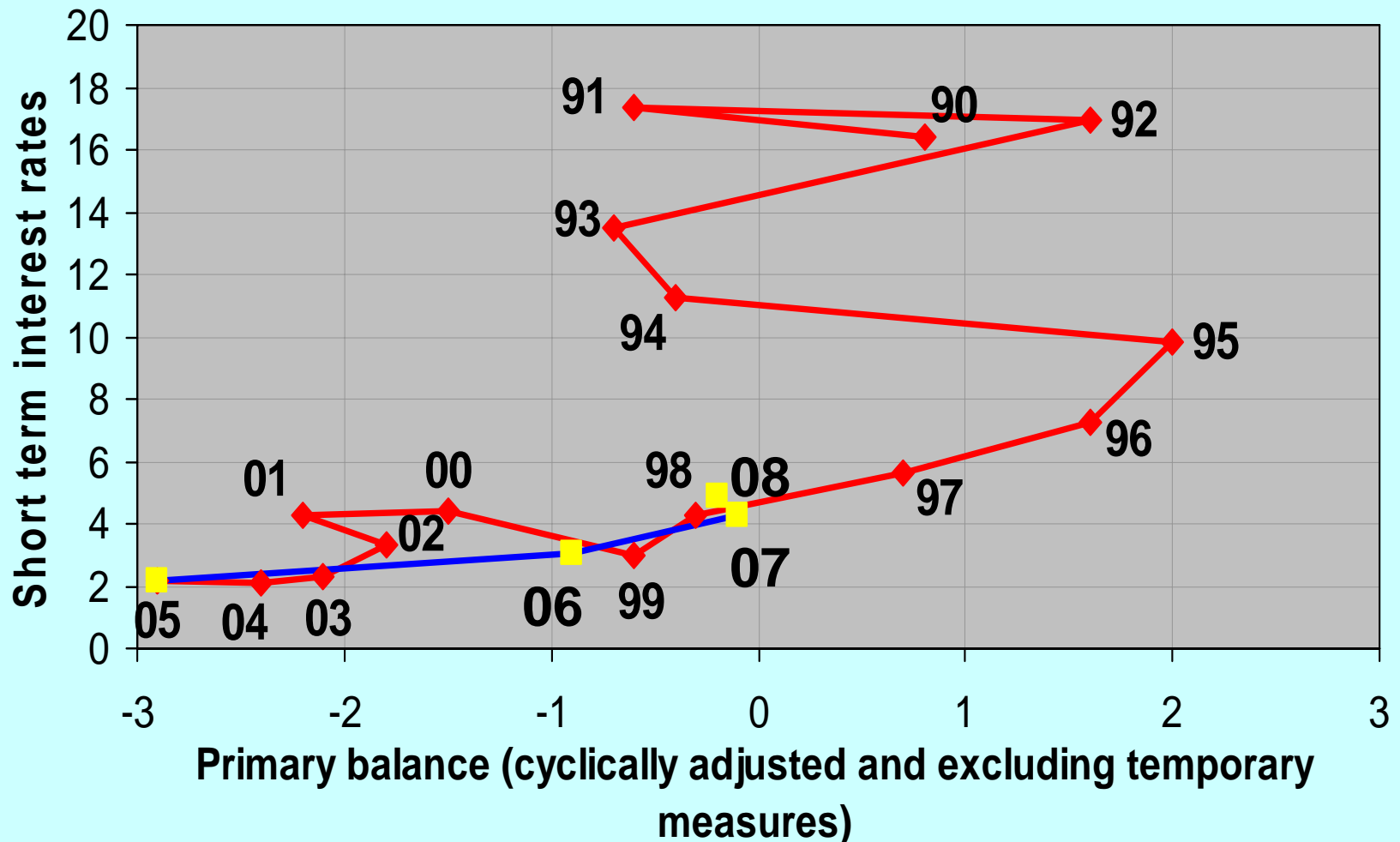
House prices in Spain, Ireland and Portugal (1996Q1=100)



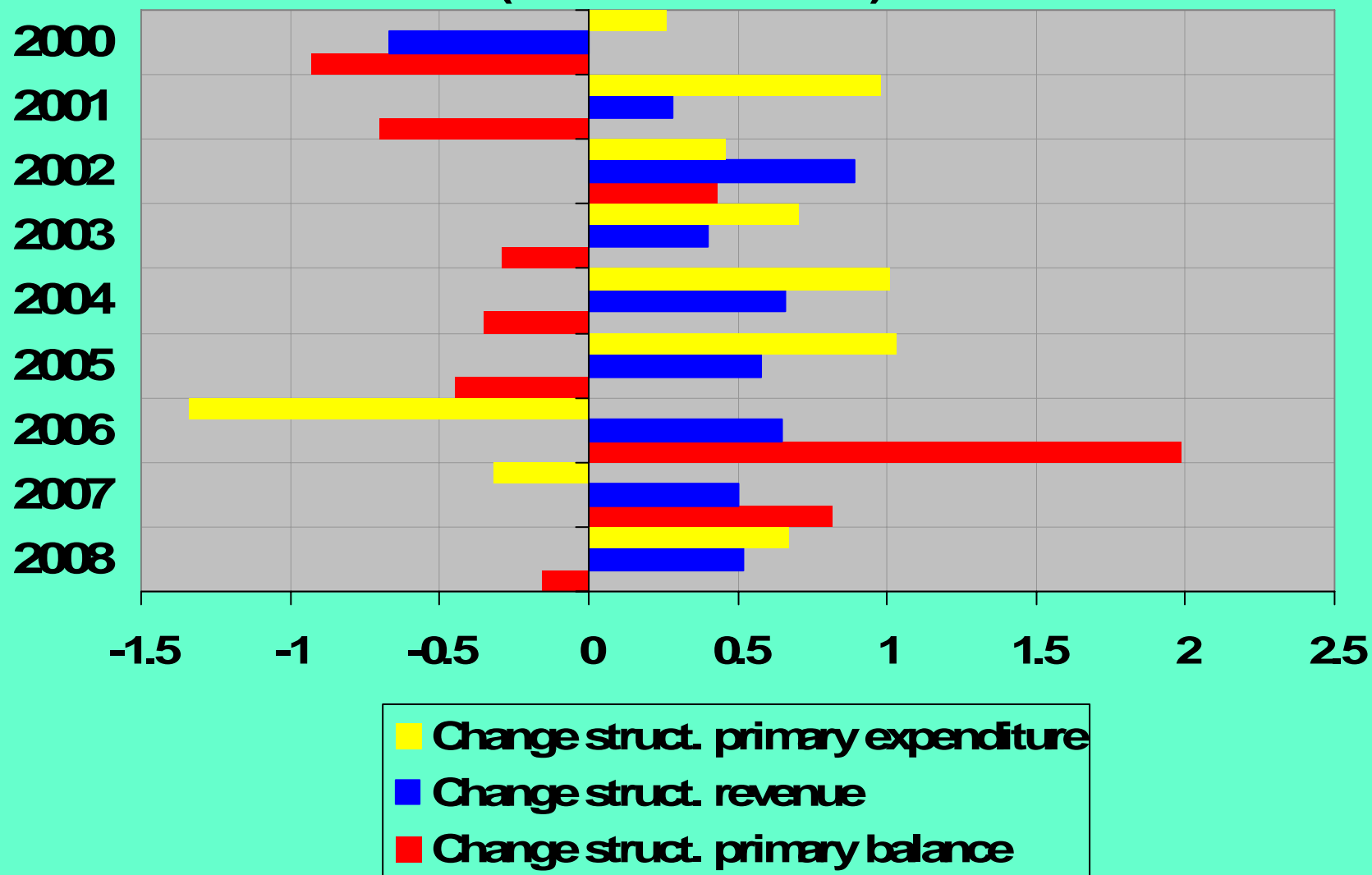
- **The sudden stop: After 2000 there was a sharp adjustment to a protracted period of lower trend GDP growth**
  - **The role of shocks: the early 00s were characterised by a deceleration of the Portuguese main trading partners and significant oil price shocks**
  - **The role of expectations' formation: the prospects of monetary unification triggered a rational intertemporal response of bringing forward consumption and investment decisions; the subsequent revision of potential growth led to a reversal in those trends. The emergence of the budget crisis of 2001 led to a collapse of expectations and of domestic demand**
  - **The Portuguese economy did not seize up fully the technological improvements that prevailed since the 90s, given its relatively low level of human capital.**
  - **The intensification of the globalization process led to significant changes in the revealed comparative advantage of the Portuguese economy. The transition to these new comparative advantages was hampered by the existence of several rigidity factors in the economy.**

# The role of fiscal policy

- Before the introduction of the euro and until 2005: (i) pro-cyclical (this behaviour exacerbated expectations concerning trend growth during the late 90s and contributed to the sharp reversion of expectations in the early 00s)

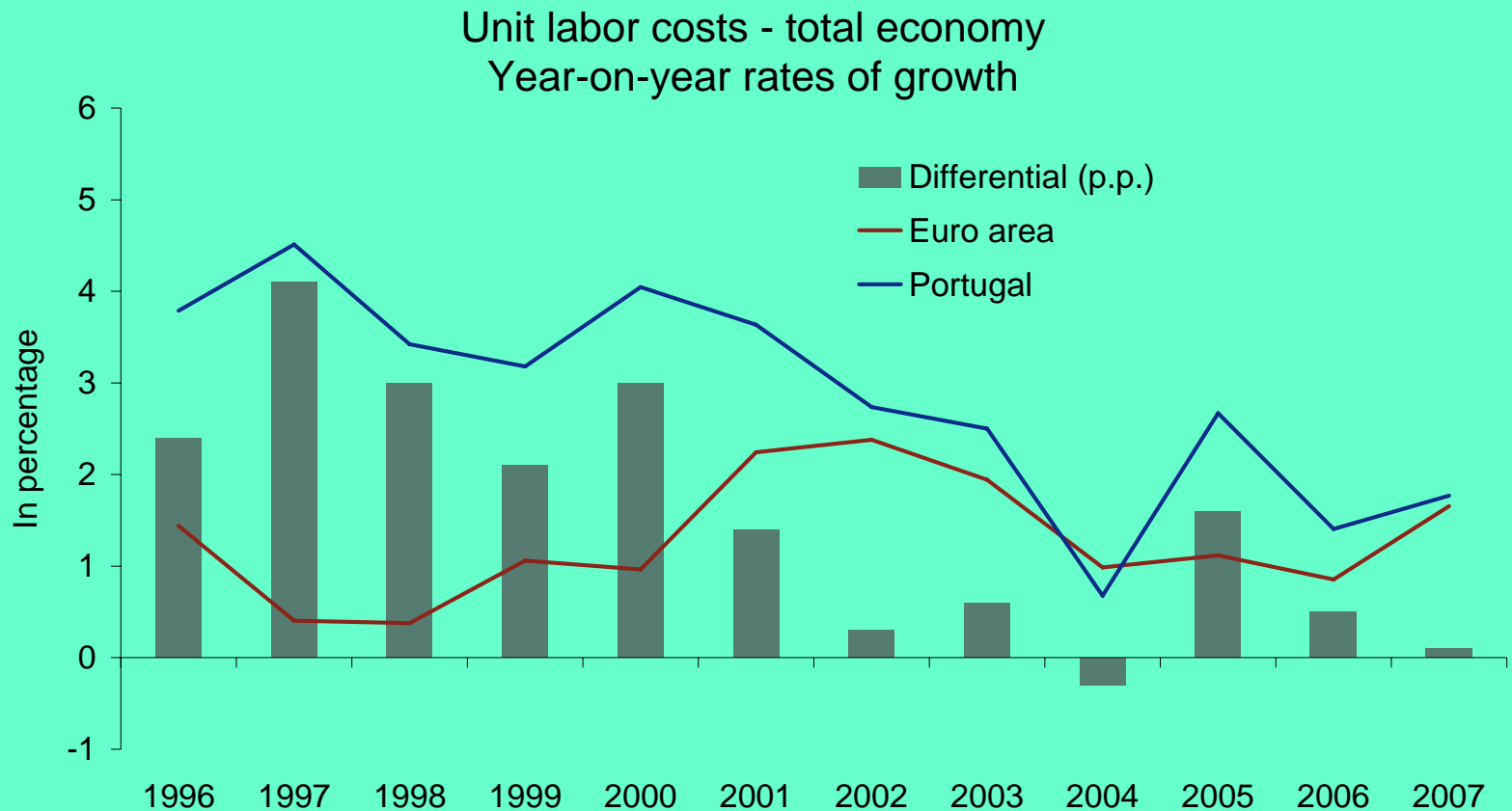


# Change of primary deficits, revenues and expenditures, cyclically adjusted and excluding temporary measures (as a % of GDP)



# The competitiveness channel: convergence of ULC growth

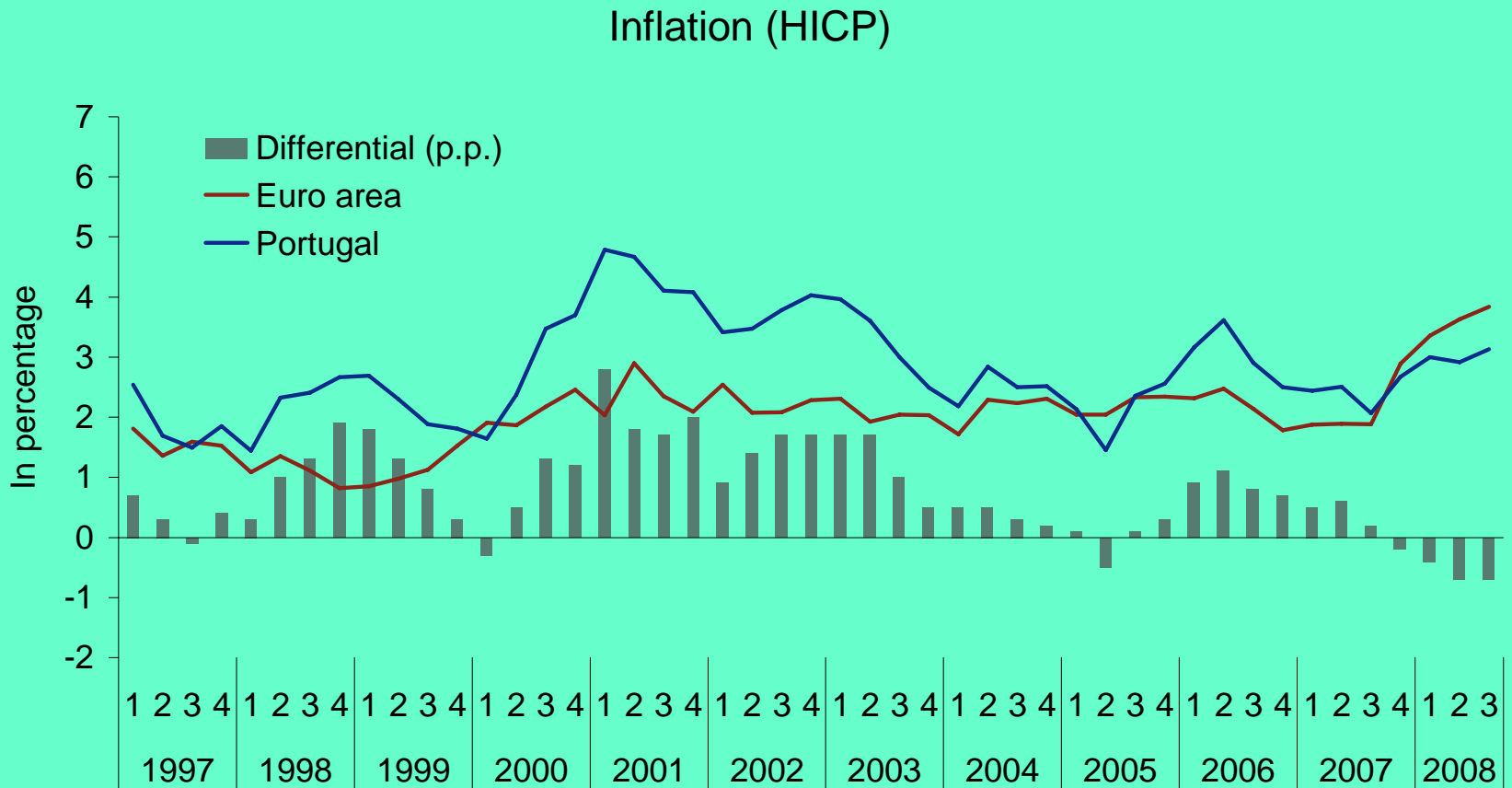
- ULC growth approached the euro area dynamics around 2002/03



Source: Eurostat, INE and Banco de Portugal.

# The competitiveness channel: convergence of inflation

- As well as inflation...

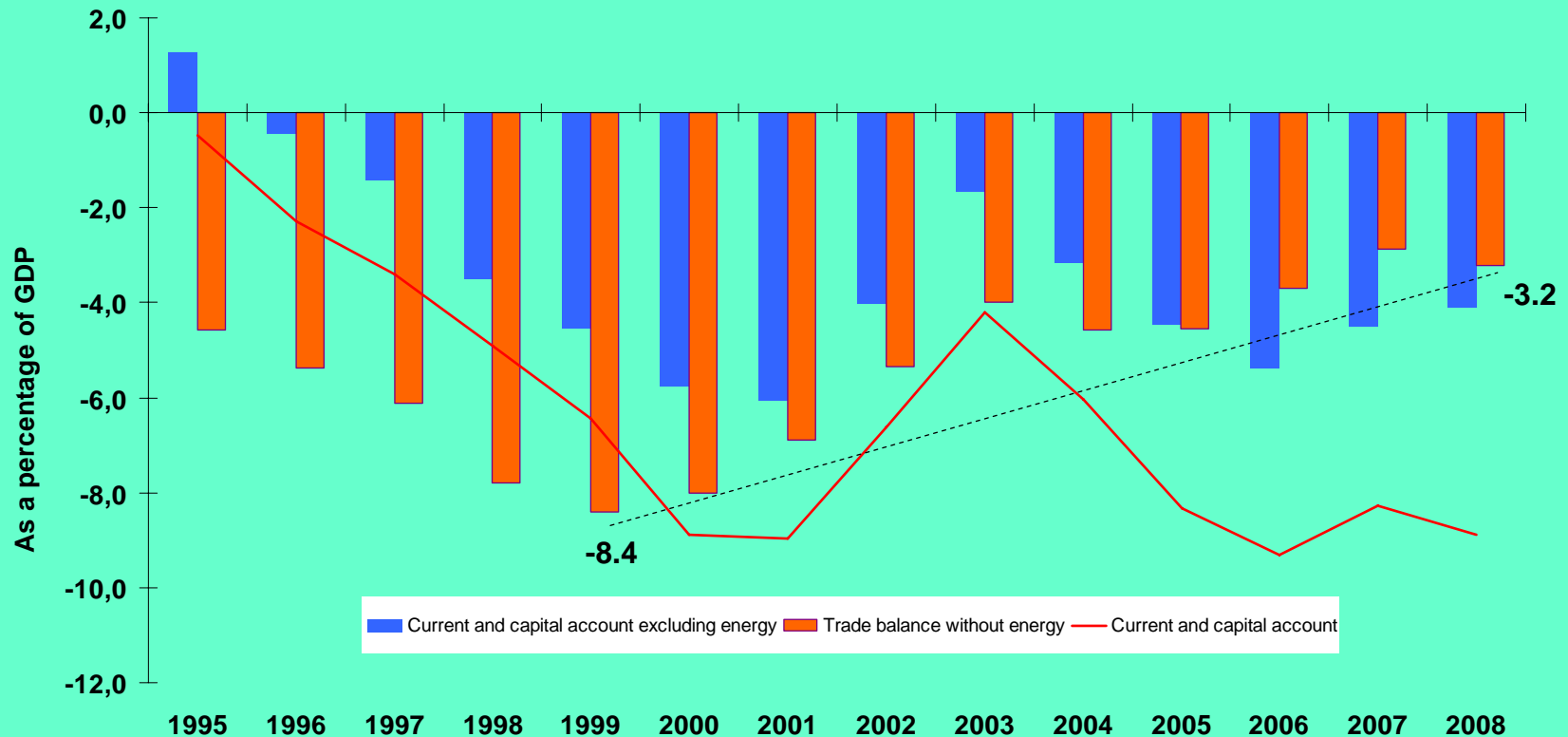


Source: Eurostat.

# External deficit: real adjustment and the oil shock

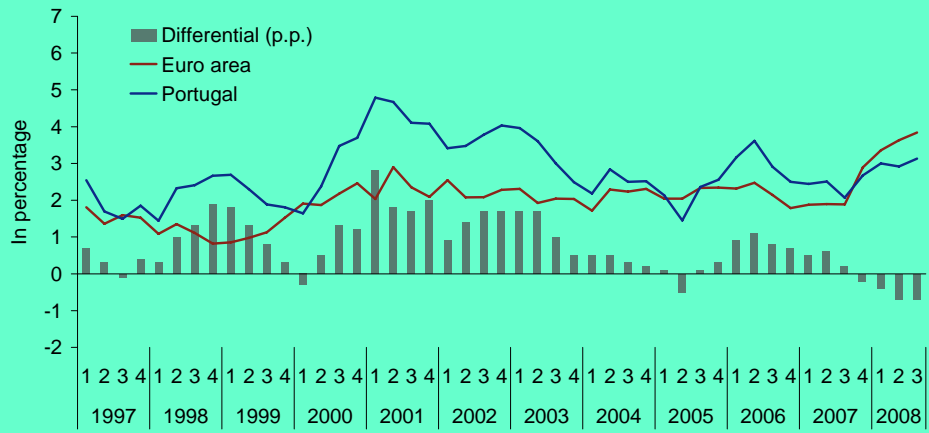
- The very favourable international financing conditions allowed an external unbalance to develop and to provide time for adjustment to a changed international competitiveness environment. There was structural adjustment but the oil shock and the financial charges on the debt contributed to maintain an high deficit

Trade, Current and capital accounts  
(with and without energy)



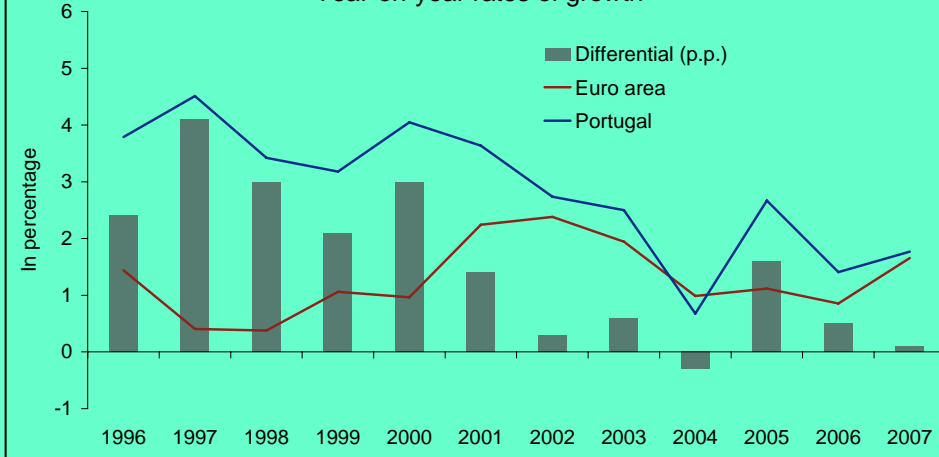
# PORTUGUESE ECONOMY: FROM BOOM TO ADJUSTMENT

### Inflation (HICP)



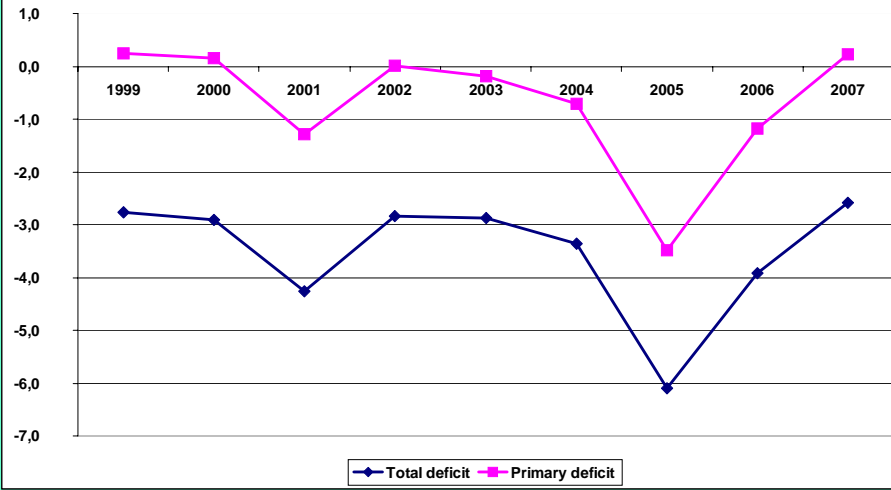
Source: Eurostat.

### Unit labor costs - total economy Year-on-year rates of growth

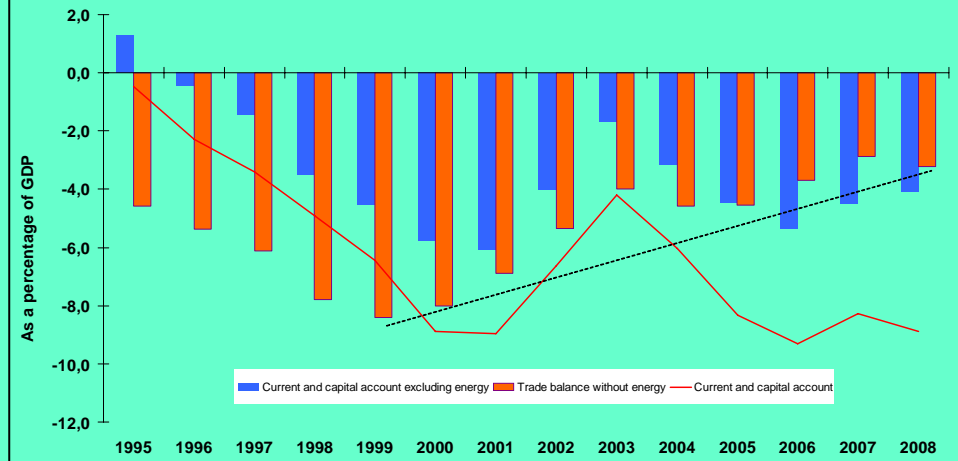


Source: Eurostat, INE and Banco de Portugal.

### Budget deficit

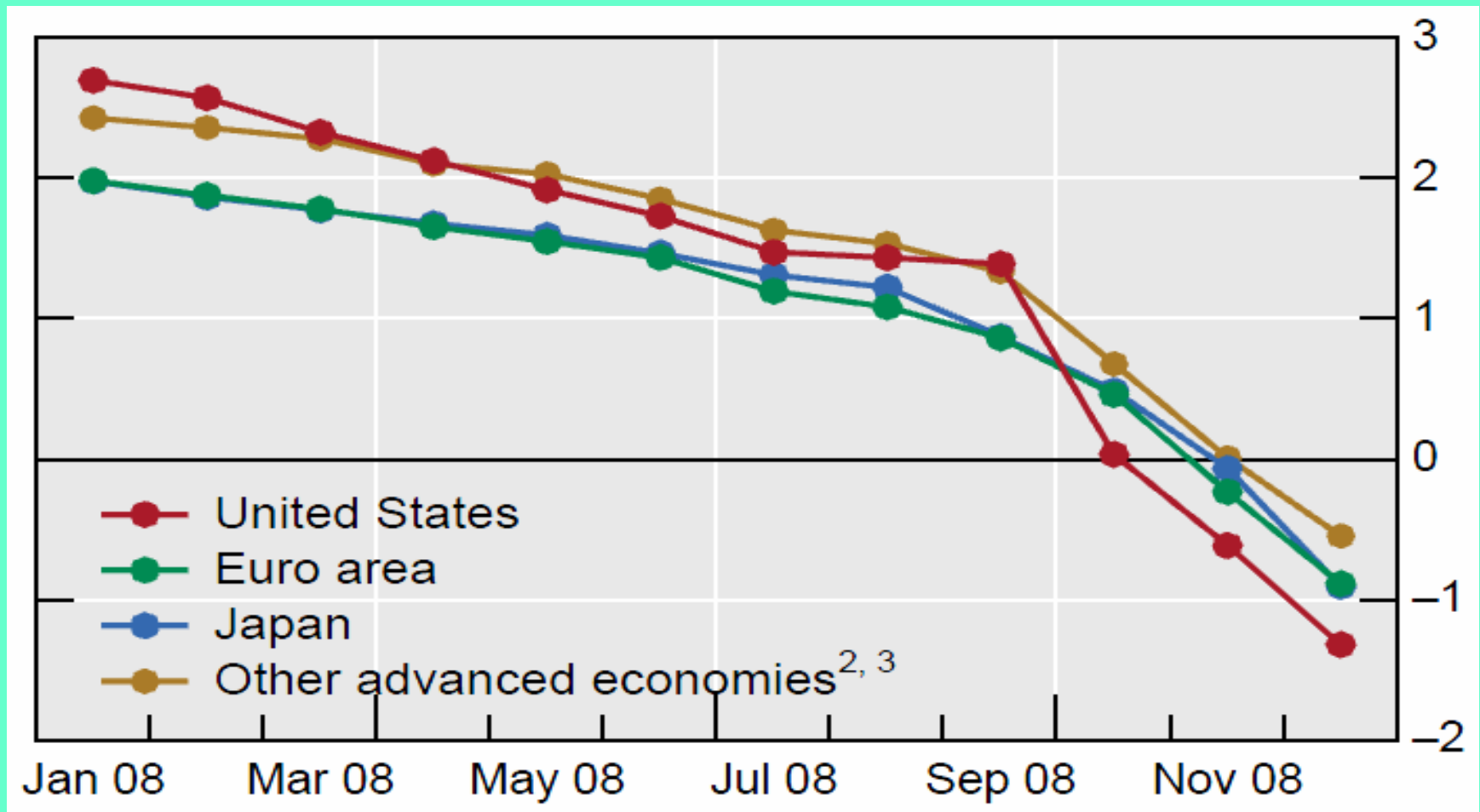


### Trade, Current and capital accounts (with and without energy)



- **Portugal in the euro: from boom to adjustment**
- **Short-term macroeconomic outlook**
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# Evolution of Growth Forecasts for 2009 since Jan 08: continuous downward revisions



Source: Consensus Economics

# Main features of the economic outlook

- The outlook is highly conditioned by the interaction between an unprecedented financial turmoil in international markets and a sharp deceleration of world economic activity.
- **Economic activity** is expected to decrease 0.8 per cent in 2009 and to increase 0.3 per cent in 2010.
- **Inflation** is expected to stand at 1 per cent in 2009 and 2 per cent in 2010, shaped to a large extent by the assumed behaviour of oil prices.
- **On the demand side**, the projections for 2009 include a fall in exports, in line with external demand, and in investment, and a moderation of consumption.
- The current projection embodies a **high uncertainty** and **downward risks for economic activity** related mostly with the international environment.

# GROWTH FORECASTS

	Date	2008	2009	Revision for 2009 in relation to previous	Date of previous forecast
For Portugal:					
GOVERNMENT	Oct 08	0.8	0.6	-1.4	Mai-08
	Jan 09		-0.8	-1.4	Oct 08
BANCO DE PORTUGAL	Jan-09	0.3	-0.8	-2.1	Jul-08
EUROPEAN COMMISSION	Out-08	0.5	0.1	-1.5	Apr 08
	Jan-09	0.2	-1.6	-1.7	Oct-08
IMF	Oct 08	0.6	0.1	-1.3	Apr 08
For the Euro Area:					
EUROPEAN COMMISSION	Oct 08	1.0	0.1		
	Jan 09	1.0	-1.9	-2.0	Oct 08
OECD	Dez 08	1.0	-0.6	-0.1	June 08

## European Commission forecasts

	GDP growth		Inflation		Budget deficit		Debt Ratio	
	2009	2010	2009	2010	2009	2010	2009	2010
<b>USA</b>	-1.6	1.7	0.4	0.7	-4.8	-4.4	67.4	70.9
<b>U.K.</b>	-2.8	0.2	0.1	1.1	-8.8	-9.6	62.6	71.0
Euro Area	-1.9	0.4	1.0	1.8	-4.0	-4.6	72.7	75.8
<b>Germany</b>	-2.3	0.7	0.8	1.4	-2.9	-4.2	69.2	72.3
<b>France</b>	-1.8	0.4	0.8	1.5	-5.4	-5.0	72.4	76.0
<b>Austria</b>	-1.2	0.6	1.2	1.6	-3.0	-3.6	62.3	64.7
<b>Belgium</b>	-1.9	0.3	1.1	2.0	-3.0	-4.3	91.2	94.0
<b>Spain</b>	-2.0	-0.2	0.6	2.4	-6.2	-5.7	46.9	53.0
<b>Portugal</b>	-1.6	-0.2	1.0	2.0	-4.6	-4.4	68.2	71.7
<b>Greece</b>	0.2	0.7	2.5	2.7	-3.7	-4.2	96.2	98.4
<b>Italy</b>	-2.0	0.3	1.2	2.2	-3.8	-3.7	109.3	110.3
<b>Ireland</b>	-5.0	0.0	0.7	1.8	-11.0	-13.0	54.8	68.2

# Outlook for the Portuguese economy 2009-2010\*

	2007	2008(e)	2009(p)	2010(p)
<b>Real GDP</b>	<b>1.9</b>	<b>0.3</b>	<b>-0.8</b>	<b>0.3</b>
<b>Private consumption</b>	<b>1.5</b>	<b>1.4</b>	<b>0.4</b>	<b>0.6</b>
<b>Government consumption</b>	<b>0.3</b>	<b>0.2</b>	<b>-0.1</b>	<b>-0.2</b>
<b>Gross fixed capital formation</b>	<b>3.2</b>	<b>-0.8</b>	<b>-1.7</b>	<b>-0.3</b>
<b>Exports</b>	<b>7.6</b>	<b>0.6</b>	<b>-3.6</b>	<b>1.8</b>
<b>Imports</b>	<b>5.9</b>	<b>2.4</b>	<b>-1.0</b>	<b>1.5</b>
<b>Current+capital account (% of GDP)</b>	<b>-8.2</b>	<b>-9.0</b>	<b>-7.9</b>	<b>-9.4</b>
<b>HICP</b>	<b>2.4</b>	<b>2.7</b>	<b>1.0</b>	<b>2.0</b>

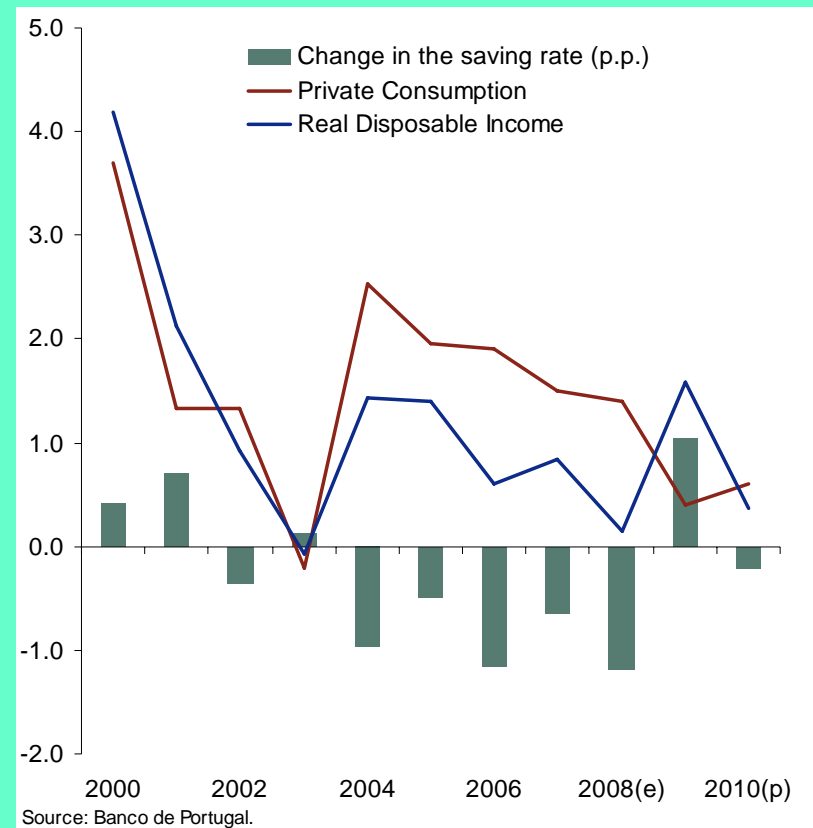
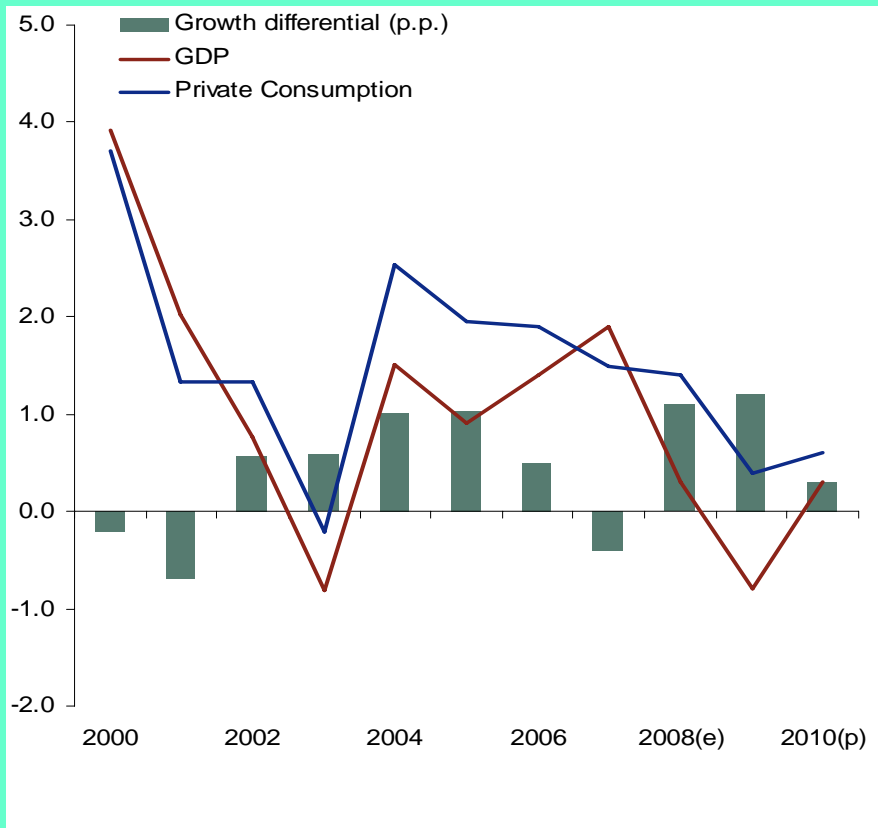
\*Published in the Banco de Portugal Winter 2008 Economic Bulletin, Jan 09

# Outlook for the Portuguese economy 2009

	<b>BofP 2009</b>	<b>EComm 2009</b>
<b>Real GDP</b>	<b>-0.8</b>	<b>-1.6</b>
<b>Private consumption</b>	<b>0.4</b>	<b>-0.2</b>
<b>Government consumption</b>	<b>-0.1</b>	<b>0.3</b>
<b>Gross fixed capital formation</b>	<b>-1.7</b>	<b>-5.5</b>
<b>Exports</b>	<b>-3.6</b>	<b>-3.8</b>
<b>Imports</b>	<b>-1.0</b>	<b>-2.8</b>
<b>Current+capital account (borrowing requirements in % of GDP)</b>	<b>-7.9</b>	<b>-8.2</b>
<b>HICP</b>	<b>1.0</b>	<b>1.0</b>

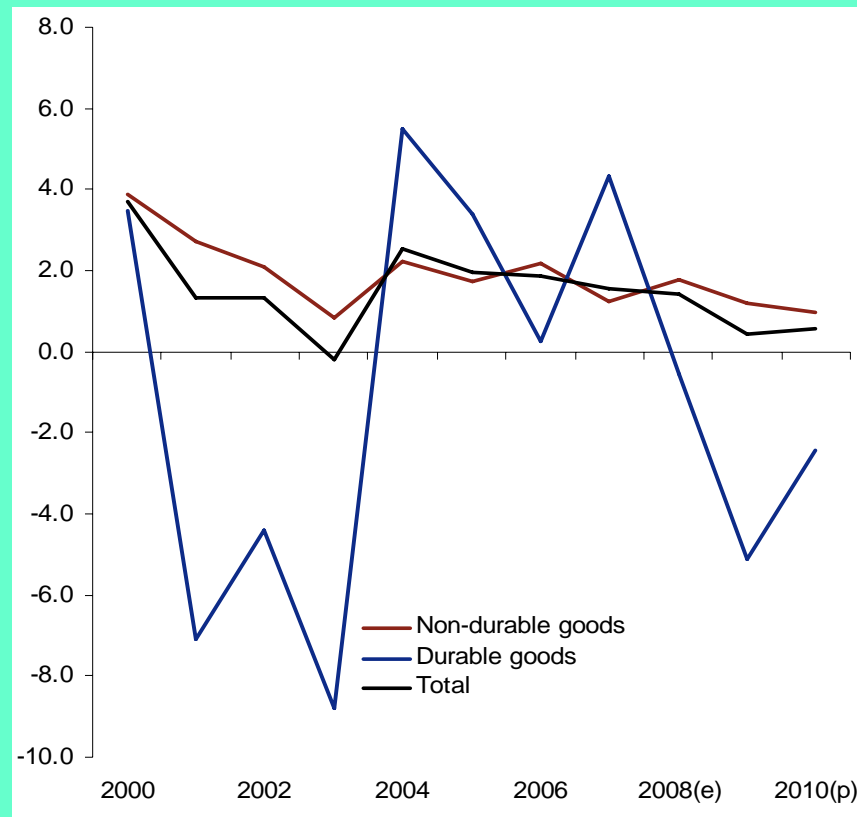
# Private Consumption

- Deceleration to relatively low levels (though higher than GDP growth)
- Recovery of the households' saving rate, namely in 2009. The availability of financial products specially designed to fit the households' budget constraints may decrease, which may hinder consumption decisions financed by new credit.
- Real disposable income in 2009 is highly conditioned by the very low level of inflation (projection of 1%).



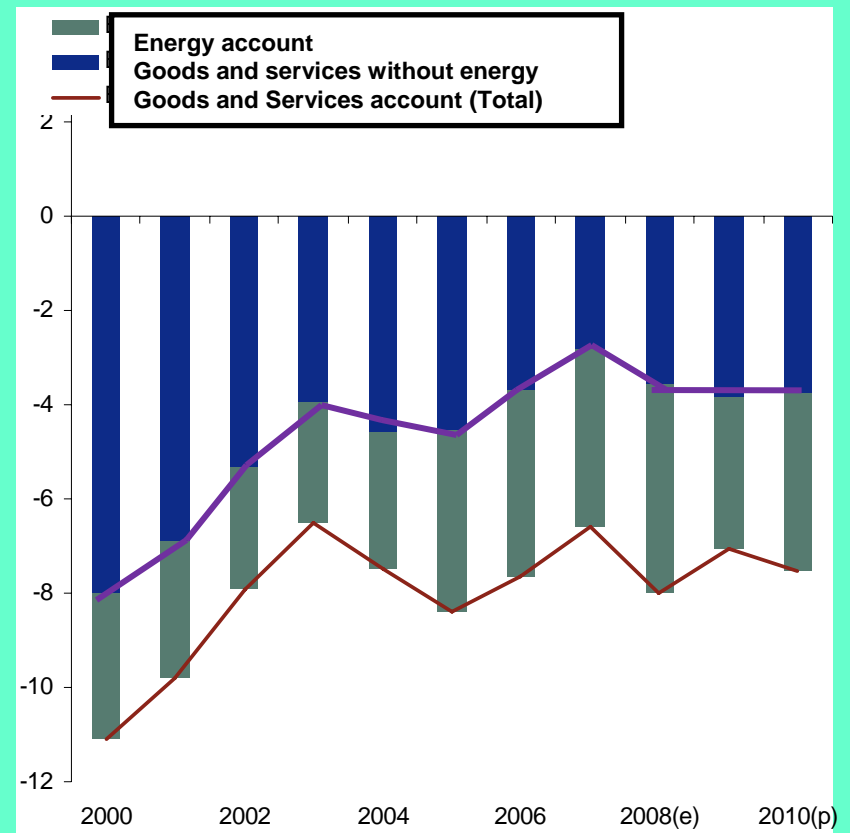
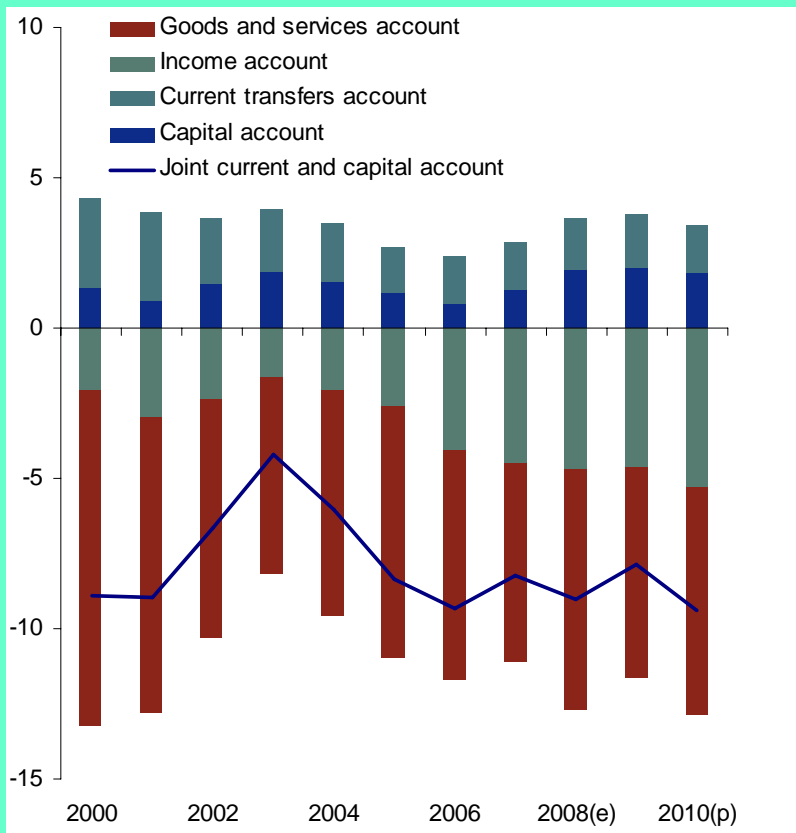
# Private Consumption

- Consumption expenditures is limited by uncertainties regarding the magnitude and duration of the ongoing financial crisis, its interaction with economic activity and its impact on wealth and labour market developments.
- Sharp decline in durables consumption (particularly in 2009) coupled with low growth in non-durables

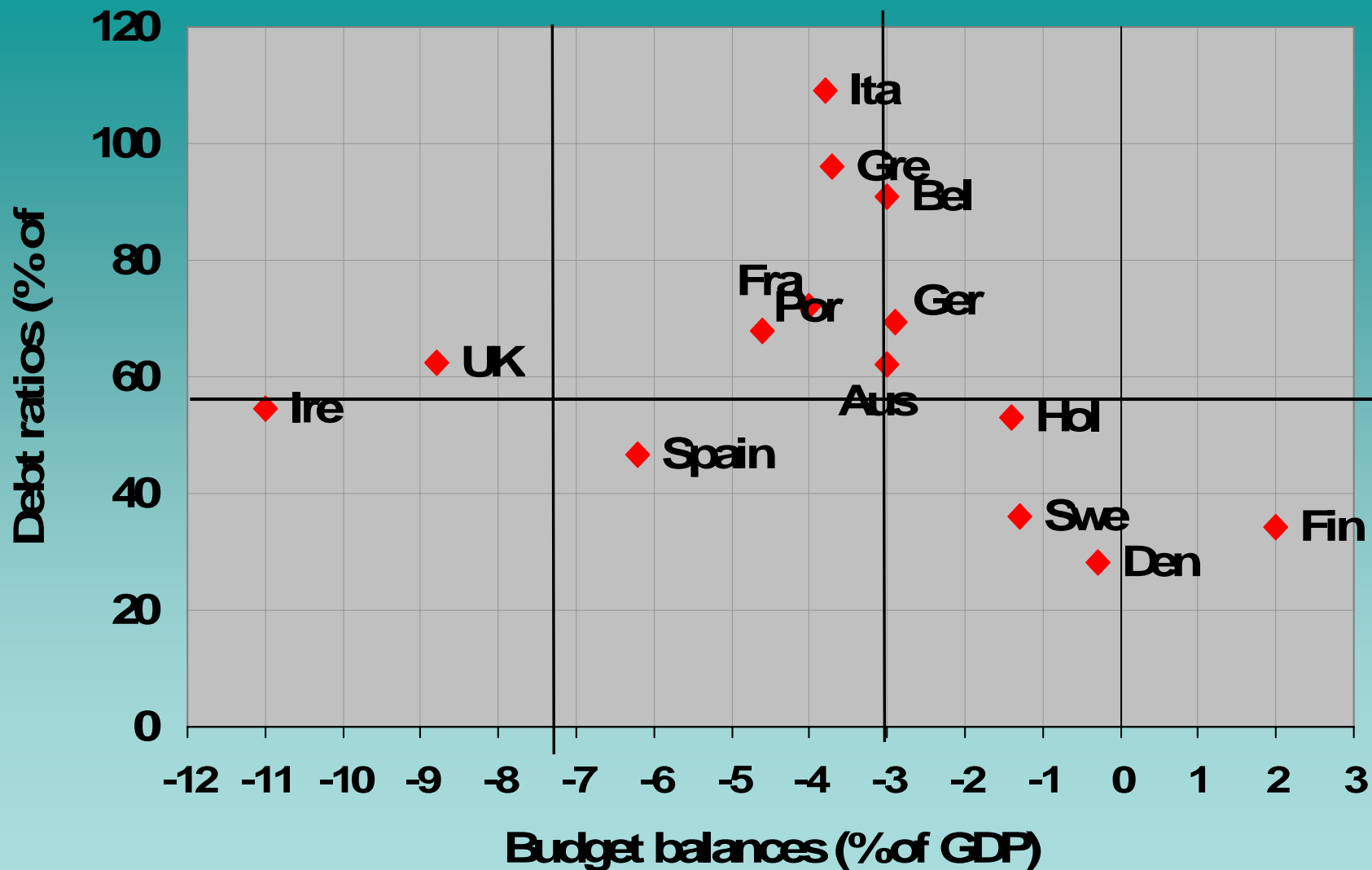


# Current and capital account

- **External financing requirements** are projected to hover around 8.5 per cent of GDP in 2009-2010.
- **Trade balance deficit** declines in 2009 and increases in 2010 due essentially to the impact of oil prices in the terms of trade.



# EU Commission: Budget balances and Debt ratios in 2009



Source: Interim Forecasts 2009, European Commission.

# Yields of 10 year Treasury bonds

	Level in Dez-07	Differential in basis points in relation to Germany	Level in 20-Jan-09	Differential in basis points in relation to Germany	Variation of the differential
<b>USA</b>	<b>4.05</b>	<b>-27</b>	<b>2,44</b>	<b>-57</b>	<b>-30</b>
<b>Japan</b>	<b>1.52</b>	<b>-280</b>	<b>1,23</b>	<b>-178</b>	<b>102</b>
<b>Germany</b>	<b>4.32</b>	<b>0</b>	<b>3,01</b>	<b>0</b>	<b>0</b>
<b>Austria</b>	<b>4.42</b>	<b>10</b>	<b>3,95</b>	<b>94</b>	<b>84</b>
<b>Belgium</b>	<b>4.47</b>	<b>15</b>	<b>4,2</b>	<b>119</b>	<b>104</b>
<b>Spain</b>	<b>4.4</b>	<b>8</b>	<b>4,19</b>	<b>118</b>	<b>110</b>
<b>Portugal</b>	<b>4.52</b>	<b>20</b>	<b>4,34</b>	<b>133</b>	<b>113</b>
<b>Greece</b>	<b>4.63</b>	<b>31</b>	<b>5,52</b>	<b>251</b>	<b>220</b>
<b>Italy</b>	<b>4.63</b>	<b>31</b>	<b>4,45</b>	<b>144</b>	<b>113</b>
<b>Ireland</b>	<b>4.5</b>	<b>18</b>	<b>5,3</b>	<b>229</b>	<b>211</b>
<b>France</b>	<b>4.42</b>	<b>10</b>	<b>3,56</b>	<b>55</b>	<b>45</b>

- Portugal in the euro: from boom to adjustment
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## Banking Sector Indicators

	Jun 2007	Dez 2007	Jun 2008	Sep 2008 (p)
<b>Capital Ratio</b>	<b>10.5 %</b>	<b>10.4%</b>	<b>9.9 %</b>	<b>-</b>
<b>Non performing loans (% of total credit)</b>	<b>1.44 %</b>	<b>1.41 %</b>	<b>1.61 %</b>	<b>1.67 %</b>
<b>Net interest margin (% of Assets)</b>	<b>1.98 %</b>	<b>1.95 %</b>	<b>1.90%</b>	<b>1.89%</b>
<b>Other revenues (Fees and Commissions, trading etc) in % of Assets</b>	<b>1.45 %</b>	<b>1.34 %</b>	<b>1.11 %</b>	<b>1.09%</b>
<b>Cost – Income ratio</b>	<b>50.1 %</b>	<b>54.5 %</b>	<b>55.6 %</b>	<b>55.6 %</b>
<b>Return on Assets (ROA)</b>	<b>1.34 %</b>	<b>1.15 %</b>	<b>0.74 %</b>	<b>0.64 %</b>
<b>Return on Capital (ROE)</b>	<b>20.6%</b>	<b>17.7 %</b>	<b>12.0 %</b>	<b>10.4 %</b>

# FITCH's Banking Systemic Risk Report (Oct 2008)

	Macro-prudential Indicator			
Categories of Banking Risk	1	2	3	Nº of Countries
A				0
B	Austria, Germany, Hong Kong Japan....	<b>UK US Hol Spain Swiss.</b> <u>Portugal</u> , France, Finland, Greece, Sweden, Denmark Norway ...(in a total of 19 countries)	<b>Australia</b> Canada Korea, Ireland, S. Africa	33
C	Israel Malasia ...	Brasil, Latvia Malta Cyprus Slovenia. Poland...		12
D	China Hungary Philippines	<b>Belgium</b> ,Bulgaria India Venezuela Ukrane Latvia Lithuania <b>Luxembourg</b> ...	Russia <b>Turkey</b> <b>Romania</b>	29
E	Argentina Bolivia ...	Bielarus	<b>Iceland</b>	12
Nº of Countries	29	40	17	86

Source: FITCH « Bank Systemic Risk Report», October 2008

- **IMF Public Information Notice (PIN) No. 08/128 October 2008**

**Portugal's financial system remains sound and well supervised. The financial system has come under pressure but has so far weathered the recent global financial turmoil, though vulnerabilities have risen. Portuguese banks' reliance on wholesale funding, the sensitivity of bank employees' pension funds and banks' own investment portfolios to stock market returns, high household and corporate debt, and significant loan concentration in some banks to certain sectors and large exposures remain sources of risk. The authorities have been pro-active in addressing these vulnerabilities; for example, banks with weaker capital ratios have been encouraged to raise capital, and the Bank of Portugal has enhanced monitoring of banks' liquidity positions and banks' plans to address potential liquidity shortfalls.**

# CONCLUSIONS

- After an estimated increase of 0.3% in 2007, real GDP is projected to decline 0.8% in 2008 and to reach a positive growth of 0.3% in 2010. Mainly reflecting the evolution of oil prices, the inflation rate is projected to decrease to 1.0% in 2009, rising to 2.0% in 2010.
- The uncertainty and risks of the current projection are unusually high. Nevertheless, the risks are on the downside both for economic activity and inflation.
- The Banking sector remains fundamentally sound and stable and has shown resilience to the protracted turbulence in international financial markets. This notwithstanding, some small institutions have been facing a more stressful situation. Liquidity conditions remain globally tight and banks have also been facing pressures on their profitability and solvency, which have led some banks to undertake capital increases. Several measures were implemented to strengthen financial stability.