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Post-Programme Surveillance Report

Portugal, Autumn 2021

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Autumn 2021

EUROPEAN ECONOMY

Institutional Paper 165

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The Post-Programme Surveillance assessment was prepared in liaison with staff from the ECB ([2]).

This report reflects information available and policy developments that have taken place until 10 October 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 autumn forecast released on 11 November 2021 (with cut-off date 25 October 2021).

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([1]) The executive summary of this report was adopted as Commission Communication C(2021)8555 on 22 November 2021. The rest of the report reflects the findings of the Staff Working Document (SWD(2021)354) accompanying this communication.

([2]) European Central Bank (ECB) staff participated in this mission, and the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

ABBREVIATIONS

BFL	Budgetary Framework Law
BPF	Banco Português de Fomento
CA	Current Account
CET1	Common Equity Tier 1
ECB	European Central Bank
EFSM	European Financial Stability Facility
ESM	European Stability Mechanism
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IGCP	Portuguese Treasury and Debt Management Agency
IMF	International Monetary Fund
INE	Portugal's National Statistical Office
MREL	Minimum Requirement for own funds and Eligible Liabilities
LCR	Liquidity Coverage Ratio
NFCs	Non-financial Corporations
NHS	National Health Service
NIIP	Net International Investment Position
NPLs	Non-performing Loans
PPS	Post-programme Surveillance
q-o-q	Quarter on quarter
RoE	Return on Equity
RoA	Return on Assets
RRF	Recovery and Resilience Facility
SMEs	Small- and Medium-sized Enterprises
SOEs	State-owned Enterprises
SURE	Support to mitigate Unemployment Risks in an Emergency
VAT	Value-added Tax
y-o-y	Year on year

EXECUTIVE SUMMARY

This report presents the findings of the fourteenth post-programme surveillance (PPS) mission of Commission staff to Portugal, in liaison with ECB staff*. Due to the existing travel restrictions, the mission took place in the form of online video meetings from 7 to 13 September 2021.*

Since the conclusion of the previous PPS mission in March 2021, Portugal's economic performance has improved substantially along with the gradual easing of restrictions imposed in the context of the COVID-19 pandemic*. After a weak first quarter of 2021, the economic recovery in the second quarter of the year outperformed expectations. Private consumption rebounded significantly as the partial relaxation of pandemic-related restrictions unleashed pent-up demand. In the third quarter of 2021, further easing of restrictions supported the recovery in the services sector while trade in goods moderated. Domestic tourism reached historical highs in July and August. Foreign tourism also started to recover but remained well below pre-pandemic levels. The country's external position also started to improve though the current account remained in a small deficit reflecting the weak recovery in net exports of services. Labour market developments appeared quite favourable as both employment and activity rates moved above pre-pandemic levels in the summer of 2021. Nevertheless, with the phasing out of government support schemes from October onwards, some economic sectors, particularly services related to foreign tourism, will continue to face risks of scarring effects. The new short-term outlook suggests that in 2021 the economy is likely to grow at higher rate than previously expected, despite a weak recovery in foreign tourism. The recovery is expected to continue at a sound pace in 2022. Risks to the growth outlook are still tilted to the downside, but appear more balanced than before, thanks to the high vaccination rate in Portugal which should reduce the risk of new pandemic restrictions.*

The COVID-19 crisis has taken a toll on Portugal's public finances*. From a small surplus of 0.1% of GDP in 2019, the budget balance turned into a deficit of 5.8% of GDP in 2020, against the background of weaker cyclical revenue and increased crisis-related spending needs. In response to the COVID-19 crisis, Portugal's fiscal policy has provided targeted support and cushioned against the negative consequences of the pandemic, especially on the labour market. Public finances are set to gradually improve in 2021 and 2022, driven by the expected economic recovery and wind-down of fiscal support. At the same time, contingent liabilities have been building up, notably linked to crisis-related public guarantees. Renewed momentum for fiscal-structural reforms remains key to enhance expenditure control and cost efficiency, strengthen the sustainability and resilience of the National Health Service, and tackle long-lasting fragilities in State-owned enterprises. Reforms in these areas are embedded in Portugal's recovery and resilience plan and have the potential to enhance framework conditions for fiscal policy, as well as to strengthen the quality of public finances.*

The banking sector confirmed its resilience to the pandemic shock, posting an overall positive net income in the first half of 2021*. Notwithstanding the continuous build-up of credit impairments, banks managed to preserve their capital ratios while still reducing non-performing loans. Lending dynamics remained positive, supported by government guarantees, record low interest rates and abundant liquidity in the financial system. However, with the expiration of the credit moratoria at the end of September 2021, the banks are facing new risks of managing credit portfolios, particularly in the corporate sector where companies in vulnerable industries are expected to have repayment difficulties. Such risks are expected to be at least partially mitigated by new policy measures aimed at smoothing the post-moratoria transition.*

Risks to financing conditions and the capacity to repay remain low. *The public debt-to-GDP ratio increased from 116.6% in 2019, to an all-time high of 135.2% in 2020, mainly owing to the significant GDP contraction and the crisis-driven primary deficit. It is set to start decreasing again in 2021, supported by the improving economic conditions and relatively low interest rates. Although financing needs surged in 2020, financing conditions remained favourable and Portugal's solid cash buffer was strengthened even further. Continuous efforts in the past to smoothen the redemption profile of public debt, extend the debt maturity, and contain interest expenditure, have contributed to mitigate vulnerabilities. Portugal's access to the EU's new instruments – namely the Support to mitigate Unemployment Risks in an Emergency (SURE) and the Recovery and Resilience Facility – have also contributed to decisively enhance its financing conditions and repayment capacity.*

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the fourteenth post-programme surveillance (PPS) mission to Portugal between 7 and 13 September 2021. Due to travel restrictions imposed during the COVID-19 pandemic, the mission took place in the form of online video meetings. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. IMF staff also attended the online meetings. PPS monitors economic, fiscal and financial conditions to assess the repayment capacity of a country that has received financial assistance. (3) While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

The current PPS reporting focused on the most relevant macro, fiscal and financial developments. Structural reforms in the real sector were analysed only in their macroeconomic context. The objective is to minimise overlaps with work and reporting related to the Commission assessment of reforms envisaged or implemented in the context of the European Semester and the Recovery and Resilience Facility.

This report reflects information available and policy developments that have taken place until 10 October 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 autumn forecast released on 11 November 2021 (with cut-off date 25 October 2021).

Uncertainty linked to the adoption of a budget for 2022 is not reflected in this report. The draft law on the State Budget for 2022 – on which Portugal's Draft Budgetary Plan of 15 October 2021 was based – was formally rejected by the Portuguese Parliament on 27 October 2021. Subsequently, on 4 November 2021, the President of the Portuguese Republic announced the forthcoming dissolution of the Portuguese Parliament and called general elections for 30 January 2022. The incumbent government will remain in office until the general elections have taken place. A new draft law on the State Budget for 2022 is expected to be presented in due course, after the general elections and when a new government has taken office. Since all these political events have taken place after the aforementioned cut-off dates, they are not covered by this report.

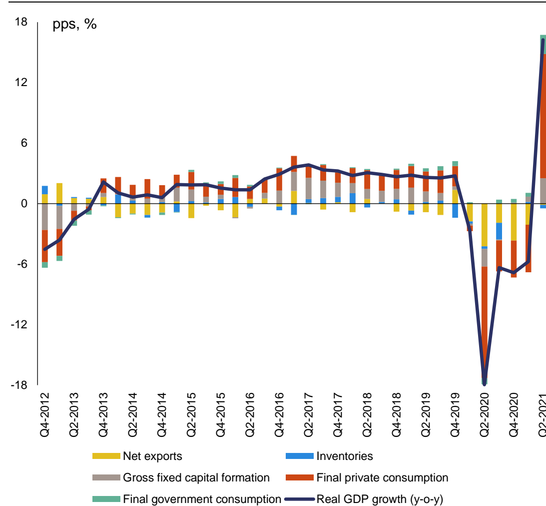
(3) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Portugal's economy rebounded strongly in Q2-2021 helped by pent-up demand. Following a decrease by 3.3% (q-o-q) in Q1-2021, driven by newly imposed COVID-19 restrictions, GDP rebounded by 4.5% in Q2-2021. The growth rate surprised on the upside due to an exceptionally strong increase of 7.3% in private consumption. This increase was driven by pent-up demand with a particularly strong rebound in trade with durable goods where the partial easing of the pandemic restrictions had a big impact on consumer behaviour. Services benefited to a lesser extent as some of the restrictions in the hospitality sector remained in place. Airline travel and foreign tourism in particular remained quite weak in Q2-2021. Investment also underperformed, contracting by 1.1% (q-o-q), but this followed three quarters of strong performance as the component continued to exceed its pre-pandemic level.

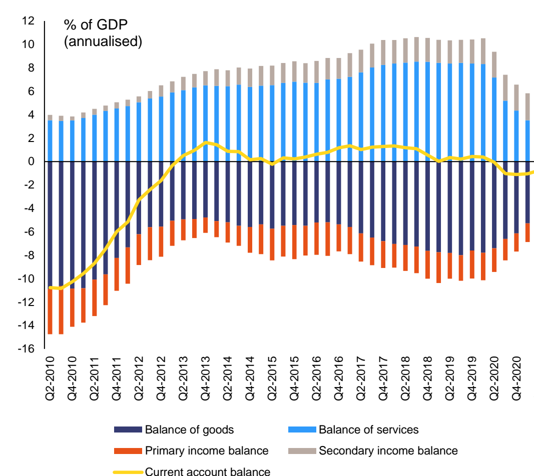
Graph 2.1: **Real GDP growth and components**



Source: Eurostat

Growth is likely to moderate in the second half of 2021. Further easing of the restrictions in the third quarter of the year supported the recovery in the service sector but at the same time retail sales moderated and industrial output even declined in the summer months due to global supply bottlenecks, particularly in the automotive industry. In the tourism sector, overnight stays of residents recovered strongly in July and August and even exceeded pre-pandemic levels, while foreign tourism visits recovered at a much weaker pace and remained well below the pre-pandemic levels. Overall, the economic situation has improved in comparison with the situation at the time of the previous mission and the growth outlook for 2021 appears more favourable. Although the challenges with foreign tourism are expected to persist in the short term, other sectors of the economy have outperformed our expectations. According to the Commission 2021 autumn forecast, GDP is set to increase by 4.5% in 2021 and 5.3% in 2022. Risks to the growth outlook are still tilted to the downside, but appear more balanced than before, thanks to the high vaccination rate in Portugal which should reduce the risk of imposing new pandemic restrictions.

Graph 2.2: **Current account balance**



Source: Banco de Portugal

The current account (CA) deficit decreased from 1.1% of GDP in 2020 to an annualised 0.8% of GDP as of June 2021. Nevertheless, the CA remained significantly worse compared to the pre-pandemic period of 2019 when it posted a surplus of 0.4% of GDP. The weak recovery in foreign tourism continued to weigh negatively on the external balance. This kept the balance in trade with services at an annualised surplus of only 3.6% as of June 2021 as compared to 8.4% in 2019. On the other hand, the deficits in trade with goods and primary income decreased while the surplus in secondary income transfers remained stable

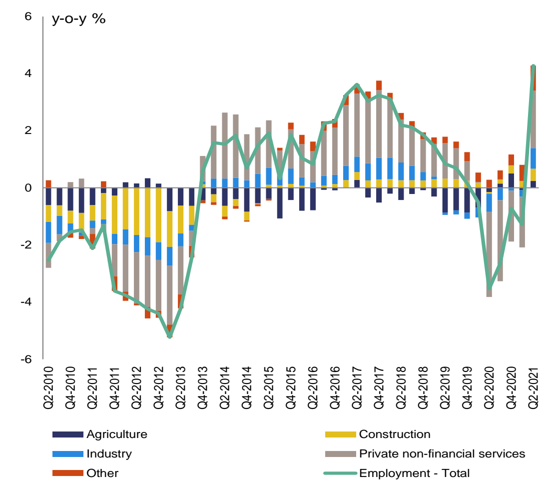
throughout the pandemic. The CA is expected to improve only marginally in the short term, as foreign tourism is recovering at a slow pace and is not projected to reach its pre-pandemic level over the forecast horizon until 2023. At the same time, a more dynamic recovery in equipment investment in the short term is set to push up imports of goods at a somewhat faster rate than exports of goods.

The net international investment position (NIIP) benefited substantially from asset valuations. Despite the CA deficit in the first half of 2021, the NIIP improved to -101.4% of GDP by the end of June 2021 relative to -106.4% at end-2020 and -100.0% at end-2019. The NIIP benefited substantially from asset revaluations in the first half of 2021, including both price and exchange rate changes with a net positive impact of EUR 3.6 billion and EUR 1.3 billion respectively. The projected increase in GDP in 2021-2023 is set to have a further positive impact on the NIIP ratio along with the expected grants under the Recovery and Resilience Facility, which is set to increase the value of non-debt inflows from abroad, particularly in the capital account of the country's balance of payments.

Most labour market indicators have recovered to pre-pandemic levels. With the gradual relaxation of COVID-19 restrictions, the seasonally adjusted unemployment rate improved from 7.0% in May 2021 to 6.4% in August 2021. The average unemployment for January-August 2021 reached 6.8%, moving below the rate from a year earlier and only marginally above the same period of 2019 when the economy was not affected by COVID-19. Employment and activity rates improved accordingly. As of July and August 2021, all main labour indicators with the exception of hours worked slightly outperformed the rates before the pandemic. Notably, the employment and labour force participation rates reached historical highs of 62.9% and 67.3% in July 2021, respectively, despite the fact that nearly 20% of the accommodation facilities remained closed. Overall, job creation in the industrial and construction sectors as well as in some specific non-contact services outweighed the job losses in tourism.

Employment growth is set to moderate as support measures expire. The labour market benefited significantly from furlough support schemes during the pandemic as well as two additional schemes for normalisation of activity and progressive resumption of activity during the periods of gradual easing of restrictions. As most of the schemes were valid for the period of pandemic-related restrictions, in place until the end of September 2021, some of the employers could face challenges keeping the level of employment after the phasing-out of the government support. This particularly applies to the tourism sector but also to car manufacturers, who have called on the government to extend support measures in light of the global shortage of semiconductors that may lead to a new wave of furloughs in the car industry. Nevertheless, overall economic recovery is expected to retain the favourable dynamics also in the labour market though at a rather slow pace. In this context, active labour market policies targeted at skill gaps, up-skilling and possible re-skilling needs will remain essential for facilitating labour mobility across sectors.

Graph 2.3: **Employment evolution by sectors**

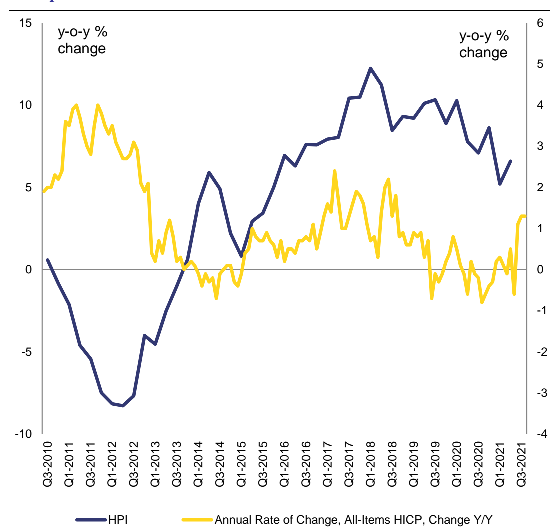


Source: Eurostat

Consumer prices picked up in Q3-2021. Consumer price inflation (HICP) increased from -0.1% (y-o-y) in Q2-2021 to 1.2% in Q3-2021 but remained well below the EU average. The low rates in spring reflected a steep fall in the price of flights and accommodation. The follow-up recovery in the two price groups as well the surge in energy prices triggered the overall rebound in inflation over the summer months. Inflation is expected to continue rising at a moderate pace over the following months pushed up by base effects in

the prices of energy until the spring of 2022 and of tourism-related services until next summer. Inflation is expected to level off afterwards under the assumption that supply bottlenecks would be gradually resolved. House prices meanwhile continued growing at a faster pace than consumer price inflation albeit with some moderation. Following an increase by 8.4% in 2020, house price growth moved down to 5.2% (y-o-y) in Q1-2021 before picking up again to 6.6% in Q2-2021. Although the availability of mortgage loans remained supportive, the growth in the mortgage stock for the same period was rather limited and property demand appeared largely driven by non-debt financing, including the accumulation of household savings in the context of low interest rates on bank deposits.

Graph 2.4: **HICP and House Price Index**

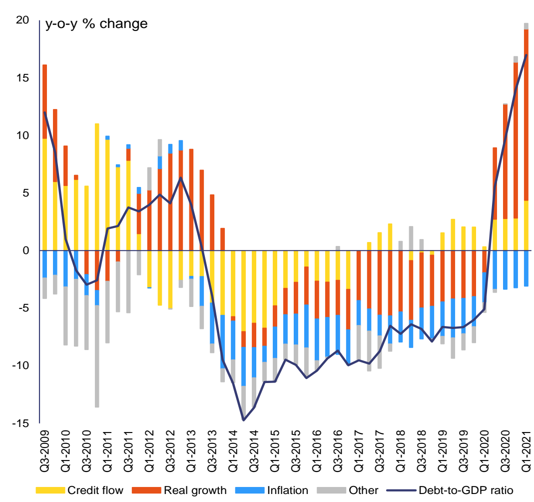


Source: Eurostat

2.2. PRIVATE DEBT

Private indebtedness continued to increase in the first months of 2021 before starting to decline in spring. In the light of negative economic growth in Q1-2021, the share of consolidated private debt increased to around 166% of GDP as of the end of March 2021 compared to 164% at the end of 2020 and 149% at the end of 2019. However, the ratio reversed to 162% at the end of June as the economy started to recover. The increase in indebtedness from the start of the pandemic until March 2021 was mainly fuelled by the denominator effect of the nominal contraction in annualised GDP and to a lesser extent by the increase in the nominal debt value. The increase was more pronounced in the corporate sector than in the household sector and was also linked to the credit moratoria and state guaranteed credit lines, which are discussed in greater detail in the financial chapter of this report.

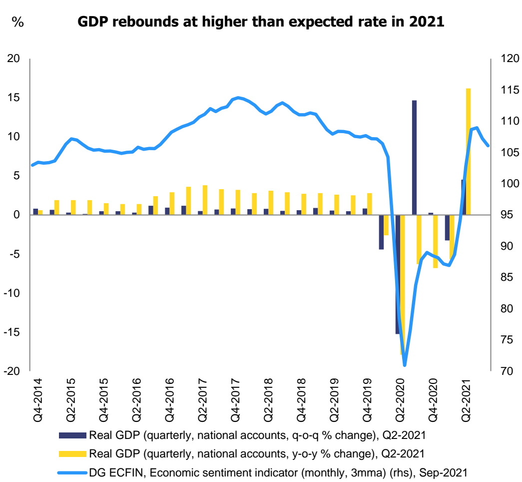
Graph 2.5: **Contributions to private debt growth**



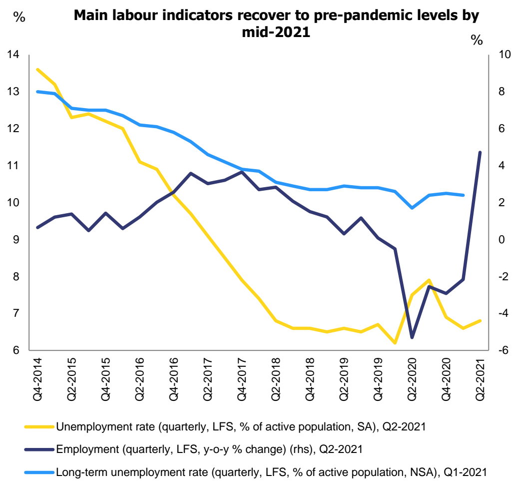
Source: Eurostat, Banco de Portugal

Private indebtedness is expected to decline as the economy is recovering. As the economy rebounded strongly in Q2-2021 and is projected to continue to grow over the following quarters, the ratio of private debt to GDP is expected to follow a favourable downward track. The current projections for economic growth and inflation appear more favourable for private indebtedness as compared to the projections in the context of the previous mission. Given the latest estimates on the evolution of the absolute value of private debt, its ratio to GDP is likely to move below 160% by the end of 2021 and to approach the pre-pandemic ratio towards the end of 2022. The financial position of the private sector is further supported by the increase in corporate deposits and household savings during the pandemic that is overall positive for the liquidity and repayment capacity of the private sector.

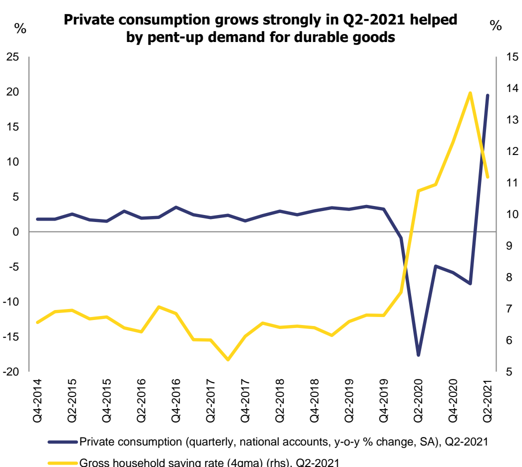
Graph 2.6: **Economic developments**



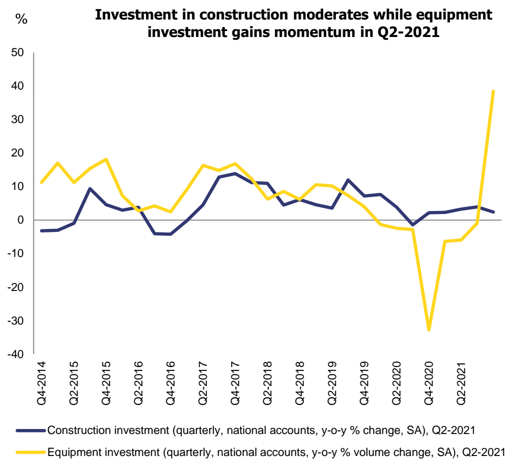
Source: INE and DG ECFIN



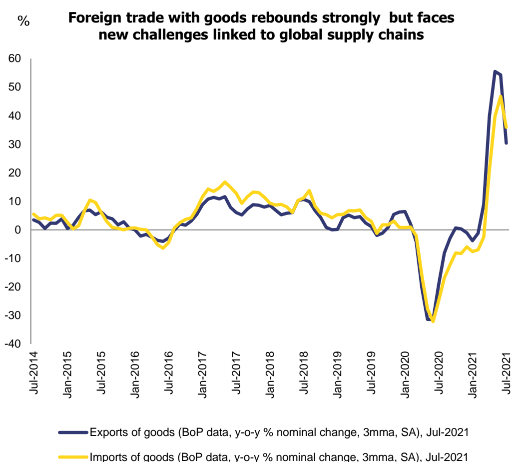
Source: INE



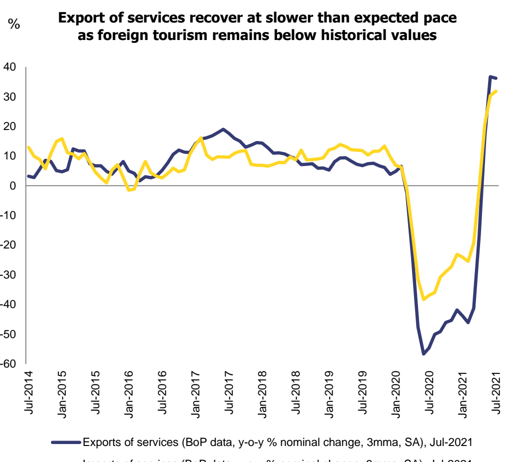
Source: INE and Eurostat



Source: INE and Banco de Portugal



Source: Banco de Portugal



Source: Banco de Portugal

Source: European Commission

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE AND OUTLOOK

The COVID-19 crisis has put Portugal's public The COVID-19 crisis put Portugal's public finances under strain in 2020. With fiscal policy being called to sustain the economy, the operation of automatic stabilisers and supportive fiscal policy measures drove the budget balance to a deficit of 5.8% of GDP in 2020, compared with the small surplus of 0.1% of GDP in 2019. Total public revenue decreased by 4.6% y-o-y in 2020 (about 2 pps. of GDP), milder than the observed contraction in nominal GDP (-6.7% y-o-y). On the one hand, this outcome was mostly driven by the decline in current public revenue by 4.5% y-o-y in 2020, on the back of receding cycle-dependent revenue, with taxes on production and imports shrinking by 9.1% y-o-y and current taxes on income and wealth decreasing more modestly by 3.7% y-o-y. On the other hand, the revenue from social contributions echoed the labour market's resilience to the COVID-19 crisis, expanding by 1% y-o-y in 2020. In turn, total public expenditure increased by 8.5% y-o-y in 2020 (about 3.6 pps. of GDP), as a result of significant increases in current public expenditure by 6% y-o-y and capital expenditure by 43.5% y-o-y. Focusing on current public expenditure, the observed increment reflected additional spending on subsidies (3.2 pps.) – under which fell the majority of the crisis mitigation measures – social benefits (1.8 pps.) and compensation of employees (0.9 pps.). In the opposite direction, there was a decrease by 8.4% y-o-y in interest expenditure (0.2 pps. of GDP), which thereby maintained the downward trend initiated in 2015.

The steady decrease of the public debt-to-GDP ratio was temporarily reversed in 2020. After having decreased to 116.6% in 2019, and following its steadily downward path since its latest peak in 2016, the public debt-to-GDP ratio spiked to an all-time high of 135.2% in 2020. In addition to the sudden primary deficit, the snowball effect (which translates the differential between the average interest rate and nominal GDP growth) and the stock-flow adjustment (which reflects the difference between the change in public debt and the deficit) concurred to this increase (by 11.2% and 4.4% of GDP, respectively). As regards the snowball effect, the unfavourable denominator effect arising from the observed contraction of nominal GDP (8.3% of GDP) added to the still non-negligible interest burden (2.9% of GDP), which has nevertheless slightly declined compared to 2019. As regards the stock-flow adjustment, it reflected, among other factors, the substantial increase of the cash buffer by EUR 9.4 billion in 2020 (close to 5% of GDP, see Section 5).

Portugal's crisis response provided targeted fiscal support in 2020, against a high degree of uncertainty. The package of crisis mitigation measures implemented in 2020 was multipronged and gradually fine-tuned as the health and economic situation evolved over the year, leading to an overall deficit-increasing impact of about 3% of GDP. In a first round, measures were taken to strengthen the response capacity of the National Health Service (NHS), including overtime work and additional hiring of healthcare workers (with a deficit-increasing impact of around 0.5% of GDP at year-end). Measures were also taken to protect jobs and livelihoods, provide adequate social support and safeguard firms' business continuity, which constituted the bulk of the overall package of measures (with a deficit-increasing impact of about 1% of GDP at year-end). One of the most important measures to protect jobs and livelihoods was a tailor-made short-time work scheme (called 'simplified lay-off' in Portugal), as well as a set of related subsequent schemes, which allowed for the temporary interruption of work or reduction of normal working time, combined with exemption from employers' social security contributions (with a deficit-increasing impact of around 0.7% of GDP at year-end). Subsequently, as restrictions were eased over the summer, new measures – taking effect as of July 2020 – were geared towards helping firms resume activity. These included the lifting of the obligation for firms to make anticipated in-year payments of their final liability under corporate income tax (with a deficit-increasing impact of 0.3% of GDP at year-end).

Portugal also supported firms through 'liquidity measures', giving rise to material public contingent liabilities. Several publicly guaranteed credit lines to firms were launched in 2020 – focusing on different target groups of firms, such as small and mid-caps, medium-sized firms, firms providing accommodation and food

service activities, or travel agencies. Most of these credit lines were under the umbrella of a publicly guaranteed scheme for investment and working capital loans to be operationalised through commercial banks, for which, in the context of the State aid Temporary Framework ([4]), Portugal sought and obtained the Commission's approval on 4 April 2020, as amended on 22 December 2020, for a maximum amount of EUR 13 billion (6.4% of GDP). The actual take-up of public guarantees is estimated to be roughly equivalent to 3 ¾% of GDP at the end of September 2021. As a rule, such off-balance sheet measures constitute contingent liabilities for the general government and may negatively impact the budget balance when certain specific conditions prevail, and in the amount that they are eventually called on. In 2020, EUR 326.1 million (0.2% of GDP) was booked under capital transfers, related to the estimated losses with respect to standardised public guarantees associated with the above-mentioned COVID-19 credit lines. In practice, up to that upper limit, future calls of such standardised public guarantees granted in 2020, and linked to those credit lines, will not be recorded as public capital expenditure and, therefore, will not affect the budget balance.

The effects of the COVID-19 pandemic have continued to affect Portugal's public finances throughout 2021. In the first half of 2021, the general government deficit (in national accounts) was 5.5% of GDP, broadly in line with the level observed in the first half of 2020. Public revenue increased by 6.9% y-o-y in the first half of 2021, led by the positive contributions from other current revenue (3 pps.), partly related to EU fund transfers, as well as from taxes on production and imports (2.1 pps.) and social contributions (1.8 pps.), linked to the gradual economic recovery. However, those developments were offset by an increase in public expenditure by 6.5% y-o-y, mainly reflecting the positive contributions from subsidies (2.7 pps.), social benefits (1.6 pps.), compensation of employees (1.1 pps.) and public investment (1.1 pps.), notably related to projects financed by EU funds such as the digitalisation of schools. By August 2021, the direct budgetary impact of crisis mitigation measures had reached about 2 ½% of GDP, arising from Portugal's short-time work schemes, direct support to firms and health-related measures (each contributing about ½% of GDP).

All factors considered, the general government balance is still expected to improve in 2021. According to the Commission 2021 autumn forecast, the general government deficit is projected to reach 4.5% of GDP this year. In 2021, government revenue is set to rebound, with tax revenue being propelled by the projected economic recovery. The intake of EU funds is expected to be sizeable, including under REACT-EU (about ¾% of GDP). In contrast to 2020, one-off measures are overall expected to support the reduction of the deficit in 2021, mostly owing to one-off revenue related to the reimbursement of the pre-paid margin that was deducted from the financial assistance loan granted by the European Financial Stability Facility (EFSF) (0.5% of GDP). The overall size of the package of crisis mitigation measures in 2021 is presently assessed as being broadly in line with that of 2020, while current spending is also expected to be compounded by pre-pandemic structural upward pressures (see Section 3.2). According to the Commission 2021 autumn forecast, the public debt-to-GDP ratio is projected to decrease to 128.1% of GDP in 2021 – thus resuming a downward path – with the swifter decline than that of the deficit partly owing to the pre-financing of 13% (around 1% of GDP) of the total amount of grants and loans allocated to Portugal under the Recovery and Resilience Facility (see Section 5). The latter was incorporated in the Commission forecast as a financial transaction, leading to a negative stock-flow adjustment and a debt-reducing effect.

Portugal's fiscal position is expected to improve in 2022, amid a wind-down of fiscal support and the projected economic rebound. According to the Commission 2021 autumn forecast, the deficit is forecast to narrow further in 2022, to 3.4% of GDP, as the economic recovery gains momentum, supported by the implementation of Portugal's recovery and resilience plan, and as crisis mitigation measures are phased out. Against that background, the public debt-to-GDP ratio is projected to further decline to 123.9% next year. At the same time, downside risks to the fiscal outlook relate, among others, to the build-up of public contingent liabilities, linked to crisis-related

([4]) The Commission adopted on 19 March a Temporary Framework (revised subsequently) to enable Member States to use the flexibility foreseen under State aid rules to support the economy in view of the COVID-19 outbreak.

publicly guaranteed credit lines and fragilities in some public corporations. The Commission 2021 autumn forecast is also surrounded by uncertainty linked to the adoption of a budget for 2022.

3.2. POLICY ISSUES

The quality of Portugal's budgetary measures is particularly important. On 20 July 2020, the Council recommended that Portugal take action in 2020 and 2021 to implement all necessary measures to effectively address the COVID-19 pandemic, sustain the economy, and support the ensuing recovery, in line with the general escape clause. ([5]) Furthermore, the Council also recommended that, when economic conditions allow, Portugal pursue fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment. Subsequently, on 18 June 2021, the Council adopted a recommendation delivering an opinion on the 2021 Stability Programme of Portugal. ([6]) The Council concluded that the measures taken by Portugal in 2020 and 2021 have been in line with the Council recommendation of 20 July 2020. However, some of the discretionary measures adopted by the government in 2020 and 2021 do not appear to be temporary or matched by offsetting measures. For 2022, Portugal was recommended to use the Recovery and Resilience Facility to finance additional investment in support of the recovery, while pursuing a prudent fiscal policy. This would imply preserving nationally financed investment, while limiting the growth of nationally financed current expenditure. Moreover, Portugal was recommended to pay particular attention to the composition of public finances, on both the revenue and expenditure sides of the national budget, and to the quality of budgetary measures in order to ensure a sustainable and inclusive recovery. Therefore, priority should be given to fiscal-structural reforms that will help provide the necessary financing for public policy priorities – namely, for investment to boost growth potential and support the green and digital transitions –, and contribute to the long-term sustainability of public finances.

Portugal's fiscal leeway remains constrained by structural upward pressures on primary current public expenditure. Primary current public expenditure expanded by 7.1% y-o-y in 2020. Excluding the direct budgetary impact of the crisis mitigation measures on the expenditure side of the budget, primary current public expenditure still increased by 1.6% y-o-y, compounded by rigid non-pandemic spending on social benefits – namely pensions reflecting Portugal's demographic ageing – and the public wage bill. Recurring increases in low pensions – above the reference rate for pension indexation (linked to inflation and GDP growth) – and the sequential widening of pathways to early retirement have continued to aggravate the underlying structural upward trend driven by demographic ageing, and contributed to a decoupling of pension spending growth from more prudent benchmarks, such as Portugal's medium-term GDP growth. Furthermore, the growth of wage-related spending excluding the budgetary cost of overtime work and temporary hiring in the NHS directly linked to the response to the COVID-19 pandemic was still significant, at 2.5% y-o-y in 2020, mostly driven by the increase in the number of civil servants, which averaged 2.2% y-o-y. Half of that increase pertained to permanent hiring in the NHS, with the remaining half mostly being associated with the education sector and municipalities. The trend of continuous growth of the public workforce culminated in the number of civil servants reaching its peak of the last decade in the second quarter of 2021, fully converging to its level prior to Portugal's economic adjustment programme.

Building a stronger budgetary framework that would offer enhanced conditions for fiscal policy-making remains a central issue. The full and effective implementation of the 2015 Budgetary Framework Law (BFL) would strengthen overall budgetary planning and monitoring through a stronger medium-term focus and enhanced transparency. However, it has experienced systematic delays. On 14 April 2021, a working group was appointed to prepare proposals for the legal framework that should underpin the new performance-oriented budgetary programmes, as well as for the creation and scheduling of a pilot that will constitute a key step

([5]) Council Recommendation of 20 July 2020 on the National Reform Programme of Portugal and delivering a Council Opinion on the 2020 Stability Programme of Portugal, OJ C 282, 26.8.2020, p. 142-148.

([6]) Council recommendation of 18 June 2021 delivering a Council opinion on the 2021 Stability Programme of Portugal, OJ C 304, 29.7.2021, p. 102-106.

towards the full and effective implementation of programme budgeting and its articulation with Portugal's multiannual budgetary framework. (7) Moreover, the implementation of the 2015 BFL envisages adherence to the new accrual-based public accounting system (that is, the '*Sistema de Normalização Contabilística para as Administrações Públicas*', SNC-AP) across all government sectors and bodies. This is taking effect gradually, with the implementation timeline currently foreseeing that the budgetary execution data will be fully compiled in accruals in 2023, with reference to 2022, and that the budgetary planning data will be fully organised in accruals in 2026, with reference to 2027. Furthermore, the bottom-up review of public expenditure – which has been ongoing since 2016 and is aimed at improving efficiency in specific areas – has progressed slowly and generated modest budgetary savings that have not yet been assessed ex post. Making decisive progress with strengthening expenditure control, cost efficiency, and appropriate budgeting remains key to facilitate the rechannelling of public resources to new strategic priorities, such as delivering on the green and digital transitions. Important reform steps towards those goals have been enshrined in Portugal's recovery and resilience plan, combined with upgrades of information systems for public financial management that are expected to contribute to making them operational.

The challenging financial situation of the NHS worsened following the outbreak of COVID-19. Since 2015, the NHS expenditure has been increasing on the back of spending on wages, medicines, and medical services, alongside inner weaknesses in budgetary planning and cost-efficiency. In the first half of 2021, the resurgence of COVID-19 cases, combined with the resumption of non-pandemic activity, exerted upward pressure on NHS spending, mainly through a higher wage bill, part of which appears to be of a permanent nature. As a consequence, and following the historically low level observed in December 2020, the accumulation of hospital arrears returned to an accelerating path shortly thereafter and spiked at EUR 675 million (more than 0.3% of GDP) in July 2021, thereby calling for additional clearance measures. In this context, total NHS debt reached EUR 2 billion (0.9% of GDP) at the end of first half of 2021, fuelling the systemic unfavourable dynamics of hospital indebtedness and recurrent bailouts by the government, with possible spill-over effects on supply-chain relationships.

Planned reforms to strengthen the NHS's efficiency and financial sustainability are delayed. On the back of recurrent high public hospital arrears, a comprehensive plan to improve the sustainability of the NHS was conceived in 2019. The plan envisioned the introduction of a new governance model for public hospitals, whereby increased autonomy in hiring and investment decisions, would be combined with stronger accountability and enhanced joint monitoring by the Ministries of Finance and Health. This strategy relied on making better use of the planning and management instruments provided for in Portugal's current legal framework for State-owned enterprises (SOEs). In particular, it foresaw revamped management contracts to strengthen accountability and encourage performance-based managerial practices, combined with efforts to ensure that hospitals' budget and activity plans were prepared under the supervision of management boards in a timely fashion, and in accordance with the quantitative and qualitative targets that would make them eligible for approval. The mandate of the task force in the driving seat of these reforms expired in September 2021, giving rise to possible implementation risks. The COVID-19 outbreak temporarily halted the implementation of these reforms, but they have now been embedded in Portugal's recovery and resilience plan. For 2021, a modest improvement of 0.1% of GDP is expected in the NHS deficit, as compared with 2020. These developments are mainly driven by additional NHS revenue, notably from substantial State budget allocations – which increased by 0.6% of GDP in 2020 and are planned to remain elevated in 2021 – as well as EU-fund transfers, and thus not necessarily by efficiency gains.

The COVID-19 outbreak put particular strain on the SOEs operating in the transport sector. The adverse effects of the COVID-19 pandemic were markedly felt by SOEs operating in the sectors most exposed to the direct consequences of the ensuing containment measures, namely the

(7) Government Order No 3771/2021 of 14 April 2021, '*Diário da República n.º 72/2021, Série II de 2021-04-14'*, p. 22.

transport sector. TAP Air Portugal – the Portuguese flag carrier – was granted rescue aid for EUR 1 200 million (0.6% of GDP) in 2020. The Commission 2021 autumn forecast factored in additional budgetary impacts of EUR 998 million in 2021 and EUR 990 million in 2022, linked to compensation for damages resulting from the COVID-19 outbreak and to the restructuring aid that Portugal intends to grant to TAP Air Portugal and for which the Commission opened an investigation to assess whether this would be in line with EU rules on State aid granted to firms in difficulty. Similarly, SATA Air Açores received rescue aid for EUR 132 million in 2020. The Commission 2021 autumn forecast includes additional budgetary impacts linked to SATA Air Açores of EUR 120 million in 2021 and EUR 130 million in 2022. These operations shall be recorded as capital transfers, thus leading to a deficit-increasing impact. In addition, by August 2021, other SOEs operating in the transport sector – namely, *Infraestruturas de Portugal*, the Lisbon and Porto subways or the national rail network – had received either capital injections or loans from the State sector for approximately 0.6% of GDP.

The COVID-19 crisis compounded pre-existing risks to the financial sustainability of SOEs. Measures to timely identify and correct deviations from SOEs' approved budgets, as well as to improve transparency and reporting standards, are being implemented at a gradual pace. The aggregate net income of SOEs was significantly affected by the COVID-19 crisis in 2020, and worsened even further in the first half of 2021. After a series of decreases in the debt-to-GDP ratio of non-financial SOEs, to 18.5% at the end of the first quarter of 2020 (of which 15.2 pps. related to SOEs inside the general government perimeter), it rose to 20% at the end of the first quarter of 2021, before moderating to 19.4% at the end of the following quarter. This evolution, however, was strongly impacted by an unfavourable denominator effect linked to the contraction of nominal GDP. To improve the governance of SOEs, the sharpening of management contracts – including the introduction therein of a new system of incentives and penalties – is envisaged in Portugal's recovery and resilience plan. In the field of public-private partnerships, the government has taken legal steps to prevent private contractors from receiving financial compensation when contractually due, for losses incurred as a consequence of the COVID-19 pandemic (for instance, in view of reduced traffic in motorways under public-private partnerships, following pandemic-related restrictions).

4. FINANCIAL SECTOR

The economic recovery helps improving the financial stability metrics. Banks became profitable again in the first half of 2021, while most lenders continue to book precautionary impairments against bad credit. Lending dynamics remained positive, supported by government guarantees, record low interest rates and abundant liquidity in the financial system. The overall balance sheet quality of local lenders has been improving throughout the pandemic as banks continued to manage actively their NPL positions and increase the average coverage ratio, which reached over 55% by mid-2021. Banks generally seem well prepared to face the expiration of debt moratoria (end-September 2021) and the gradual phasing out of pandemic-related support schemes. Going forward, the newly incorporated Promotional Bank - Banco Português de Fomento (BPF) will take an important role in supporting vulnerable firms through a targeted approach, not only through opening the possibility of post-moratoria debt restructuring (Retomar facility) but also allowing the use of equity or quasi-equity instruments managed by the EUR 1.3 billion strong Recapitalisation and Resilience Fund (Fundo de Capitalização e Resiliência) approved and financed under the Portuguese Recovery and Resilience Plan.

Corporate credit continues to outgrow lending to households. Payment moratoria and public guarantee schemes allowed firms to build-up significant precautionary liquidity buffers. Between March 2020 and March 2021, private sector deposits grew from 126% to 141% the GDP. Notwithstanding the uncertainty brought by the pandemic, the banking system continued to provide accessible credit to the Portuguese economy. Corporate lending, heavily supported through government-guarantees, continued its rising trend, but the annual growth rate of bank loans slowed down from a high of 11.2% - reached in February 2021 - to 5.2% in August 2021. Lower demand for corporate credit in recent months comes as a consequence of abundant liquidity in the NFC sector, high indebtedness of Portuguese firms and the recent introduction of more stringent and targeted criteria for public support measures. It is noteworthy that, while in 2020 there was a stronger increase of loans granted to NFCs in sectors most affected by pandemic restrictions (mostly to companies needing to meet financial obligations while lacking income), in 2021 credit growth patterns were quite similar across the entire corporate universe. Concerning credit to households, the recent growth in house prices has been accompanied by increased availability of mortgage loans. The annual growth rate in household credit accelerated from 1.7% (y-o-y) in January 2021 to 3.2% (y-o-y) in June 2021, the highest expansion in retail credit on record since 2010. Fixed-rate mortgages have recently gained some ground (with a 5.7% share in all mortgages in 2020), but variable rates remain overly prevalent (82.3% share in 2020) [8], which makes debt service payments highly sensitive to future shifts in interest rates. However, at the end of June 2021, 92% of the stock of mortgages had a loan-to-value ratio (LTV) of 80% or less, in line with Banco de Portugal's macroprudential recommendation on new credit agreements for consumers issued in July 2018. Furthermore, the share of residential real estate transactions financed with domestic bank credit has remained stable at around 40% since end-2016, significantly lower than in the period preceding the sovereign debt crisis (66% in 2009). These aspects play a stabilising role and help offset the build-up of systemic risk.

Domestic banks remain very liquid on the back of significant deposits' growth and the ECB's accommodative monetary policy. Portuguese banks continue to benefit from favourable market funding conditions. In the first half of 2021, banks reported a surge in clients' deposits reaching historical high levels of EUR 286 billion in Q1-2021 against EUR 280 billion in Q4-2020. Consequently, the sector displays a very comfortable funding and liquidity profile. The banks' liquidity coverage ratio (LCR) stood at 266% in Q1-2021, 20 p.p. above the end-2020 figure and well above the minimum legal threshold of 100%. With the transformation ratio dropping to just 70% and the inability to pass on negative interest rates to NFC and retail customers, this build-up of liquidity comes at a penalising price for the sector.

MREL requirements have been set and communicated to credit institutions. In line with earlier authorities' recommendations, Portuguese

[8] Banco de Portugal: Relatório de Acompanhamento dos Mercados Bancários de Retalho 2020 (July 2021).

Table 4.1: **Financial stability indicators**

in %	Portugal								Euro area	EU
	Q4-2017	Q4-2018	Q4-2019	Q1-2020	Q2-2020	Q3-2020	Q4-2020	Q1-2021	Q1-2021	Q1-2021
Non-performing loans	13.3	9.4	6.1	5.9	5.5	5.3	4.9	4.6	2.4	2.4
o/w NFC sector	25.2	18.5	12.3	11.9	11.1	10.6	9.8	9.3	4.7	4.6
o/w HH sector	7.1	5.1	3.7	3.7	3.6	3.5	3.4	3.4	2.9	2.9
Return on equity(1)	-0.8	2.7	4.3	1.9	0.3	1.2	0.0	4.1	7.1	7.3
Return on assets(1)	0.0	0.3	0.5	0.2	0.1	0.1	0.0	0.4	0.5	0.5
Total capital ratio	15.2	15.2	16.7	16.7	17.2	17.6	18.1	17.7	19.1	19.3
CET 1 ratio	13.9	13.2	14.1	14.1	14.6	14.9	15.4	15.2	15.8	15.9
Loan to deposit ratio	78.9	76.2	76.4	75.7	72.1	73.1	72.1	70.3	84.8	87.9

(1) Annualized data
Source: Banco de Portugal and ECB

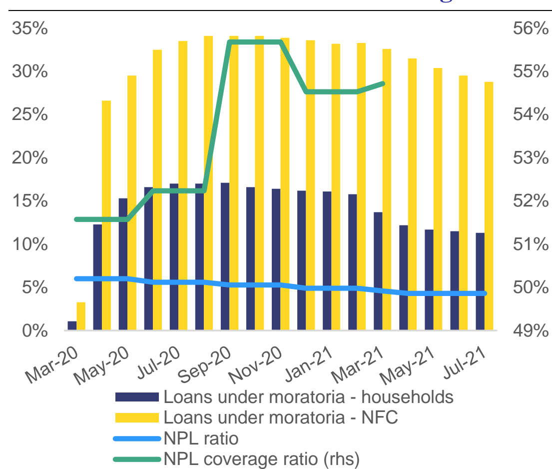
banks have also focused efforts on preserving their loss-absorbing capacity and building anti-crisis buffers. Banco de Portugal has notified individual MREL requirements to all banking groups whose resolution plans envisage the use of resolution tools, when applicable, as determined by the Single Resolution Board. Some banks have recently stepped up their issuance of liabilities deemed eligible for the MREL ratio, taking advantage of current favourable market conditions. As a general rule, the transition period towards a fully financed anti-crisis buffer only ends in 2024, and most lenders are committed to spread the issuance evenly, also meeting on the way the interim 2022 targets. This translates into around EUR 2.5 billion of MREL issuances per calendar year.

Extraordinary support measures introduced at the onset of the pandemic are being phased out. COVID-19 related moratoria and public guarantees allowed banks to support many companies impacted by the sanitary crisis. Naturally, banks' balance sheets were heavily impacted by the sizeable use of moratoria, both by households and firms. In July 2021, over 29% of loans to NFC were still under moratoria (EUR 21.8 billion), one of the highest shares of loans subject to moratoria in the EU. This represents a decrease from figures recorded in September 2020, when 34% of total loans to firms were under moratoria (EUR 25.2 billion). The sectors of activity most affected by the pandemic made greater use of this support measure (EUR 7.9 billion) weighting 36.4% of total bank loans under moratoria. As moratoria expired at the end of September 2021, the Government's new economic policy measure, named Retomar, aims at helping smooth the post-moratoria transition. Under this programme, banks will have an incentive to restructure loans previously covered by moratoria of economic viable companies, by awarding a state-backed guarantee of up to 25% of the restructured exposure.

Public guarantees represent the second pillar of support to the economy. As of August 2021, the total amount of loans and companies benefitting from public guarantee schemes in Portugal amounted to EUR 8.8 billion and 65 000 companies respectively. The average guarantee coverage ratio ([9]) stood at 84%, which equals to EUR 7.4 billion, close to the legal maximum capital endowment of EUR 9.6 billion of all schemes. In this respect, 26% of the new loans granted between March 2020 and June 2021 were guaranteed. While originally guarantees covered the entire corporate space, more recently, the guarantee schemes have been targeting support to the hardest-hit sectors, such as tourism and contact-intensive services. Some instruments have not only been scaled down, but also modified, for instance in terms of eligibility criteria or the number of beneficiaries. Certain schemes now foresee the possibility to convert 20% of the loan into a grant if firms keep their employees.

([9]) Portion of the credit exposure that the scheme guarantees to pay financial institutions when the beneficiary is unable to pay back.

Graph 4.1: **Evolution of loans under moratoria, NPL ratio and NPL coverage ratio**



Source: Banco de Portugal

Notwithstanding the impact of the pandemic, banks remain committed to balance sheet cleaning. Continuing the trend observed over the last years, NPLs decreased further, to 4.3% (from a high of 17.2% at end-2016 and 4.9% at end-2020). The major drivers of this change have been the sale and write-off of NPLs, but also the increase of gross loans at the denominator. Loans moratoria together with other public support schemes, mitigated asset deterioration on banks' books, raising however concerns over possible cliff-effects on defaults once these measures are withdrawn. In this respect, the share of loans qualified as Stage 2 (pre-NPL) has already increased significantly, accounting in June 2021 for 10.9% of total gross loans, and for 27.3% of loans under moratoria (up from 8.8% and 15.2% respectively, in June 2020). Exposures to NFC have so far been the most affected by the pandemic, but even this sector recorded only incremental increases in Stage 2 loans, and no surges in forbearances. The large stock of impairments booked by banks in the course of 2020 and, to a lesser extent, of 2021, provide them with a sizeable buffer towards adverse shocks, reflected in the improving coverage ratio (55.5%). Ultimately, the full impact of the sanitary crisis on the quality of the balance sheet will most likely manifest itself only in the coming 12 to 18 months.

The new Promotional Bank aims to increase the effectiveness of support to Portuguese firms. BPF was incorporated only recently in Q4-2020 with EUR 255 million equity capital. Similarly to international peers, the new institution is supervised by the central bank and remains subject to banking regulation with respect to capital, compliance and governance issues. BdF is in the process of consolidating most of development finance and was founded with the aim to eliminate the overlapping of state support, avoiding dispersion in different institutions and ultimately increasing the support effectiveness provided to companies. On top of the already existing wholesale focus, a retail dimension will be added to the equity and lending products. BPF is fully in line with the strategy underlying the Portuguese Recovery and Resilience Plan with a strong focus on increasing the resilience of the corporate sector, digitalisation and supporting the sustainability of the Portuguese economy. The Portuguese Recovery and Resilience plan foresees for the BPF to receive an additional EUR 250 million of capital to increase its capability and will also be managing a major element of the Portuguese recovery and resilience plan, namely a new equity and quasi-equity fund with an initial endowment of EUR 1.3 billion. In the short run however, BPF is playing a key role in managing the plethora of COVID-19 related guarantees including the Retomar programme aimed at transitioning the vulnerable part of the economy from moratoria towards a support free environment.

The judicial system continues to face efficiency challenges. Despite many improvements over the recent years, the justice system continues to struggle with bottlenecks across many areas. Many courts are still busy with cases dating back to the financial crisis, which heavily affects the statistics of completed enforcement actions and insolvency cases. The observed increase in the average length of completed cases is indeed explained by the high number of older cases that were completed in the first quarter of 2021. In fact, in Q1-2021 65.4% of the completed insolvency cases, as well as 46.4% of the completed civil enforcements, were over 5 years old. Consequently, the average length of the completed civil enforcement actions increased by over 2 years in 2021, compared to 2007. On the positive side, reforms aimed at making the system more efficient are being implemented and monitored. The Portuguese Recovery and Resilience Plan also includes measures to support the transformation of the justice system into a leaner, agile and more digitally advanced judicial

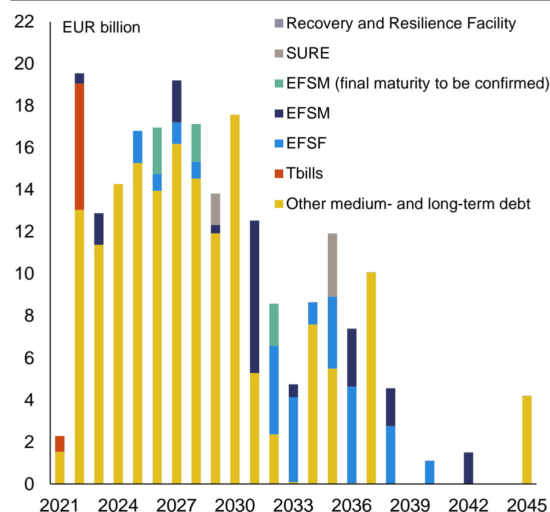
system. In that respect a set of procedural issues are being addressed through current and future legislative changes. Constraints are being removed inter alia in the summons stage, establishing as a rule the electronic summons of firms in the insolvency proceeding. Amendments to the Insolvency and Corporate Recovery Code (CIRE) should also simplify the processing of verification and ranking of creditor claims. Furthermore, the creditor rights will be strengthened with the revision of the preferential regime for the right of retention in relation to mortgage credit. Human resources have been notoriously an issue over the past years. Even if the staff size has recently increased, the reforms aim to further expand the number of magistrates and judicial officials of Commercial Courts and create more targeted and specialised teams of clerks at various levels of the judicial system. As various COVID-19 related support measures are slowly being phased out, courts and extrajudicial processes are bound to play a key role in preserving viable firms and swiftly addressing probable new insolvencies and related collateral damage in form of NPL.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Portugal's debt management strategy has contributed to ameliorating its risk exposure. Against the background of historically low interest rates, Portugal's debt management strategy in recent years has targeted the dual objective of smoothening the redemption profile of public debt by capping upcoming annual peaks in redemptions (see Graph 5.1), and containing interest expenditure. In particular, liability management exercises – such as buy-backs and government bond exchange offers – have succeeded in extending the average debt maturity and reducing interest expenditure. After having fully repaid its financial assistance loans to the IMF by December 2018, Portugal undertook a first repayment to the EFSF of EUR 2 billion in October 2019 (which had been originally due in 2025). Moreover, Portugal has committed to a first repayment to the EFSM of EUR 0.5 billion in 2022, subject to market conditions. ([10]) The average residual maturity of Portugal's public debt has remained broadly stable at around 8 years, with a slight increase in the first half of 2021. Moreover, the Portuguese public debt issuances remained attractive to investors and government bonds were reaffirmed as the main funding instrument. Particularly noteworthy was Portugal's syndicated issue of long-term government bonds, on 3 February 2021, with a 30-year maturity and a 1% coupon. In addition, the investor base continued to be diversified and broadened across regions and types of investors, with the Eurosystem, banks and public entities acting as the main players.

Although the pandemic has weighed heavily on Portugal's financing needs in 2020 and 2021, this was not at the expense of its cash buffer. With the outbreak of COVID-19, Portugal's financing needs surged, mainly driven by a worsening of the primary budget balance, which turned into a deficit in 2020 for the first time since 2014. That notwithstanding, the lower-than-planned deficit in 2020, among other factors, led to a higher-than-expected cash buffer (as measured by general government deposits) in 2020, which increased by about EUR 9.4 billion to a substantial cash position of EUR 23.9 billion (11.9% of GDP) at the end of the year. Despite the projected decrease of the primary deficit, higher debt redemptions by close to EUR 5 billion (2.4% of GDP) are expected to lead Portugal's financing needs in 2021 to increase by EUR 3.6 billion (1.9% of GDP), as compared to 2020, which would be consistent with the country's total borrowing requirements reaching EUR 28.1 billion (13.3% of GDP) this year. Portugal's cash buffer is planned to be reduced by about EUR 9.6 billion in 2021, bringing it down to EUR 14.3 billion (about 6.8% of GDP) and, therefore, closer to pre-pandemic levels.

Graph 5.1: **Redemption profile of public debt**



Debt outstanding as of: 30-09-2021
Source: Treasury and Debt Management Agency

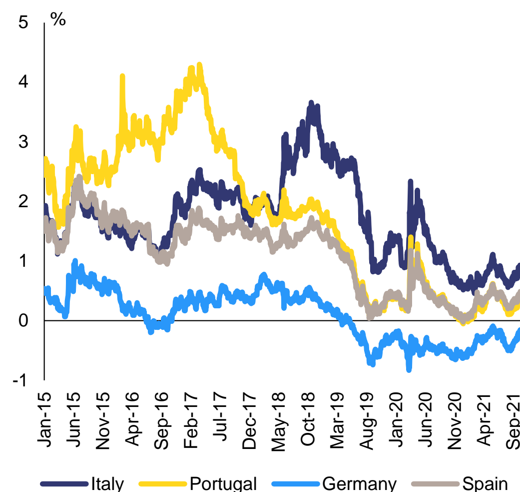
New sources of EU support have eased Portugal's heightened financing needs in 2020 and 2021. Financing resources at the EU-level were made available to support Member States in deploying fiscal policy measures to mitigate the social and economic impact of the COVID-19 pandemic and prompt the economic recovery. In order to assist Portugal's increase in public expenditure related to short-term work schemes and similar measures, on 25 September 2020, and following a Commission proposal, the Council approved a loan to Portugal for a maximum of EUR 5.9 billion (3% of GDP), under the recently available Support to mitigate Unemployment Risks

([10]) Commission Decision of 26 August 2019 relating to the waiving of the Union's rights under the mandatory proportionate repayment clause to the EFSM Loan Facility Agreement between the Union and the Portuguese Republic, C(2019) 6264 final.

in an Emergency (SURE). ([11]) A total of EUR 5.4 billion have already been disbursed to Portugal, of which EUR 3 billion on 1 December 2020 and EUR 2.4 billion on 25 May 2021. Moreover, on 13 July 2021, and also following a Commission proposal, the Council approved the assessment of the recovery and resilience plan for Portugal, which is geared towards investments and reforms to sustain the economic recovery, strengthen economic resilience and foster the green and digital transitions. ([12]) The total EU financial contribution allocated for Portugal's plan is EUR 16.6 billion (about 8% of GDP), including grants (this is, non-repayable support) amounting to EUR 13.9 billion and loans amounting to EUR 2.7 billion. The release of instalments is conditional on Portugal satisfactorily fulfilling relevant milestones and targets, which shall be completed no later than 31 August 2026. That notwithstanding, a pre-financing payment for EUR 2.2 billion (1% of GDP) – equivalent to 13% of the amount of grants (EUR 1.8 billion) and loans (EUR 0.4 billion) allocated to Portugal – was already made available on 3 August 2021.

Portugal's public debt-to-GDP ratio is set to start decreasing again in 2021, while remaining vulnerable to shocks. In 2020, Portugal's public debt-to-GDP ratio reached its historical peak of 135.2% of GDP. According to the Commission 2021 autumn forecast, the public debt-to-GDP ratio is projected to decline to 128.1% in 2021, driven by a favourable growth-interest rate differential and debt-reducing stock-flow adjustment. It is projected to moderate further to 123.9% in 2022, and to 122.7% in 2023. On the basis of the Commission's debt sustainability analysis, Portugal is projected to face non-negligible fiscal sustainability risks in the medium term (see Annex 1). Importantly, Portugal's public debt-to-GDP ratio is not projected to steadily decline in the Commission's 'no-fiscal policy change' scenario, nor in plausible alternative deterministic and stochastic scenarios. While there are mitigating factors, notably linked to the public debt profile and the solid cash buffer, the Commission's debt sustainability analysis indicates that Portugal's public debt-to-GDP ratio is particularly sensitive to shocks, highlighting the need to persevere with prudent fiscal policies and growth-oriented structural reforms to strengthen the sustainability and resilience of Portugal's public finances in the medium term. The risks to the pace of public debt reduction are somewhat tilted to the downside in view of the build-up of public contingent liabilities – on top of non-negligible pre-pandemic levels – arising from some public corporations and the private sector, notably if the calling of public guarantees granted during the COVID-19 crisis possibly ends up exceeding current expectations.

Graph 5.2: **10-year government bond yields**



Source: European Commission

Portugal's market financing conditions were favourable by the cut-off date of this report. Since October 2018, all four relevant rating agencies have maintained the 'investment' grade to Portugal's public debt. In spite of the worsening of the fiscal outlook associated with the COVID-19 pandemic, ratings for Portugal have remained stable in 2021, a trend observed since 2019. Particularly noteworthy was Moody's recent decision, on 17 September 2021, to upgrade Portugal's rating from Baa3 to Baa2 with a 'stable' outlook, driven by their expectations that Portugal will see improvements in its long-term growth prospects due to 'Next Generation EU' and the implementation of structural reforms, as well as

([11]) Council Implementing Decision (EU) 2020/1354 of 25 September 2020 granting temporary support under Regulation (EU) 2020/672 to the Portuguese Republic to mitigate unemployment risks in the emergency following the COVID-19 outbreak, OJ L 314, 29.9.2020, p. 49-54.

([12]) Council Implementing Decision of 13 July 2021 on the approval of the assessment of the recovery and resilience plan for Portugal (ST 10149/21+ADD 1 REV 1).

that its debt burden will decline in the coming years due to stronger growth and improved effectiveness of fiscal policy-making. The accommodative monetary policy stance within the Eurosystem – in particular, the set of policies implemented by the ECB in response to the COVID-19 crisis – have contributed to preserve Portugal's favourable financing conditions. Since its peak at the onset of the sovereign debt crisis, the implicit interest rate on Portugal's public debt has experienced a declining trend and reached 2.3% in 2020, driven by the lower interest rates associated with new issues. Following a period of heightened volatility at the outset of the COVID-19 crisis, the yields on Portugal's government bonds have since declined for all maturities and attained historically low levels (see Graph 5.2). The country's 10-year government bonds spreads have stabilised close to pre-pandemic levels, thereby attesting the convergence of Portugal's yields with those of its main European peers.

Sovereign financing and the capacity to repay remain sound. Portugal's high debt-to-GDP ratio and inherent vulnerabilities continue to require close and regular monitoring. In the short term, Portugal's capacity to repay is secured, benefiting from stable and relatively low yields, and anchored in a solid cash buffer capable of cushioning against potential future needs. In the medium to long term, prudent and more growth-friendly fiscal policies, combined with structural reforms to boost potential growth, would be important to strengthen the sustainability and resilience of Portugal's public finances and, thus, the country's capacity to repay.

ANNEX 1
European Commission debt sustainability analysis

The debt sustainability analysis (DSA) uses the Commission 2021 autumn forecast as a starting point. This approach allows to ensure cross-country consistency and to factor in second-round macroeconomic effects. The Commission's DSA covers the period 2021-2032, relying on alternative assumptions for the development of key variables over the medium-term to yield the baseline scenario and a series of alternative deterministic and stochastic scenarios. Noteworthy, the baseline projections revert to a standard 'no-fiscal policy change' scenario, which assumes that the primary budget balance – in structural terms and before ageing costs – remains constant at its last forecast value (2023) for the remainder of the 10-year projection horizon. In contrast, this standard 'no-fiscal policy change' assumption had been adjusted in the previous reports published since autumn 2020, in light of the unprecedented impact of the COVID-19 crisis, including on the structural primary balance. ([13]) The assumptions on real GDP growth continue to build on the latest short-term Commission forecast for the years 2021-2023. For the period 2024-2032, the projections now include the expected growth impact of Next Generation EU, including the investments under the Recovery and Resilience Facility based on the Commission's *t+10* simulations, adjusted on the basis of the QUEST model. ([14]) This simulation is carried out simultaneously for all Member States, hence it also includes spill-over effects. Inflation assumptions beyond the short term build on market expectations measured by the '10-year 10-year' inflation-linked swaps until the tenth forecast year, hence they are consistent with the market expectations on sovereign financing costs.

Portugal's public debt-to-GDP ratio has been severely impacted by the COVID-19 crisis. Whilst Portugal's public debt-to-GDP ratio was on a declining path prior to the COVID-19 pandemic, it reached an all-time high in 2020, when it soared by almost 19 pps. to 135.2%. A sudden primary deficit and an unfavourable denominator effect drove the observed increase. According to the Commission 2021 autumn forecast, the public debt-to-GDP ratio is projected to start decreasing again in 2021, when it is set to moderate to 128.1%. The projected decrease in the public debt-to-GDP ratio in 2021 reflects the expected rebound in GDP growth and persistently low interest rates. This is compounded by a debt-reducing stock-flow adjustment owing to the positive difference between the amount of disbursed grants under the Recovery and Resilience Facility in 2021 – notably, their 13% pre-financing this year – and the associated actual spending. The public debt-to-GDP ratio is projected to decline further to 123.9% in 2022, and to 122.7% in 2023. At the same time, risks to the public debt outlook remain tilted to the downside, owing to the build-up of contingent liabilities from crisis-related public guarantees – whose calling may exceed current expectations – thereby adding to pre-pandemic vulnerabilities.

Portugal is projected to face non-negligible fiscal sustainability risks in the medium term. According to the Commission's 'no-fiscal policy change' baseline scenario – whereby the structural primary balance (before ageing costs) is assumed to remain constant at the forecast level for 2023 (that is, a structural primary deficit of 0.8% of GDP) ([15]) – the public debt-to-GDP ratio is set to

([13]) In the previous reports published since autumn 2020, rather than assuming a constant structural primary balance at its last forecast value, the baseline scenario assumed a correction of fiscal positions over the medium term (that is, the structural primary balance was set to converge back to its pre-crisis forecast value). This adjusted baseline scenario aimed at accounting for the fact that the last forecast value (for 2022) for the structural primary balance was strongly affected by the COVID-19 crisis and, notably, by the impact of the temporary fiscal policy measures adopted in response to the COVID-19 crisis, thereby providing an inadequate reference to set an assumption for the medium-term fiscal position. This is no longer considered to be the case, especially as the latest forecast value now refers to 2023 in the Commission 2021 autumn forecast.

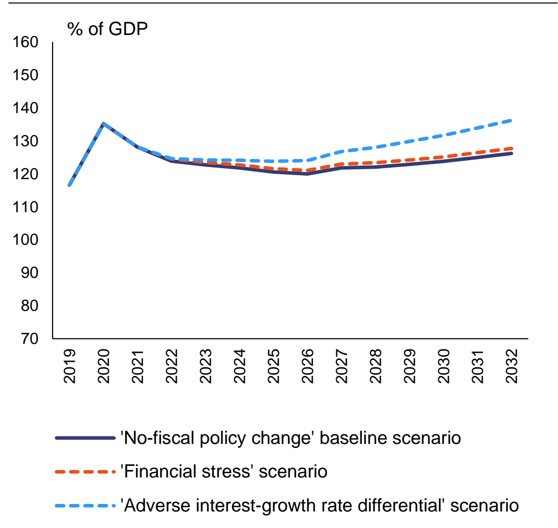
([14]) Simulations by the Commission services show that the recovery and resilience plan, together with the rest of the measures of the European Union Recovery Instrument, has the potential to increase the GDP of Portugal by between 1.5% and 2.4% until 2026, not including the possible positive impact of structural reforms, which can be substantial. This, *ceteris paribus*, contributes to influence positively debt sustainability.

([15]) In detail, the assumptions underlying the Commission's 'no-fiscal policy change' baseline scenario notably comprise: (i) a structural primary deficit, before ageing costs, fixed at 0.8% of GDP as of 2023; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years from now); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based 10-year forward nominal rates; (iv) real GDP growth rates on average slightly below 1%; and, (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, 20 November 2020).

remain on a steadily downward path until 2026, while it would start increasing as of 2027 (see Graph A1.1). Crucially, the public debt-to-GDP ratio over the projection horizon would be consistently above its pre-pandemic level at the end of 2019, while remaining broadly stable as compared to its projected level for 2021. The Commission's DSA confirms the unfavourable effect of the COVID-19 crisis on Portugal's public debt-to-GDP ratio, which is projected to only gradually unwind. This effect is markedly compounded by the projected increase in ageing costs over the projection horizon, reflecting the underlying structural upward trend driven by demographic ageing in Portugal. That notwithstanding, mostly favourable interest-growth differentials are projected according to the Commission's baseline scenario, thanks to the growth-friendly impact of Next Generation EU, including the investments under the Recovery and Resilience Facility, in a continuously low interest rate environment.

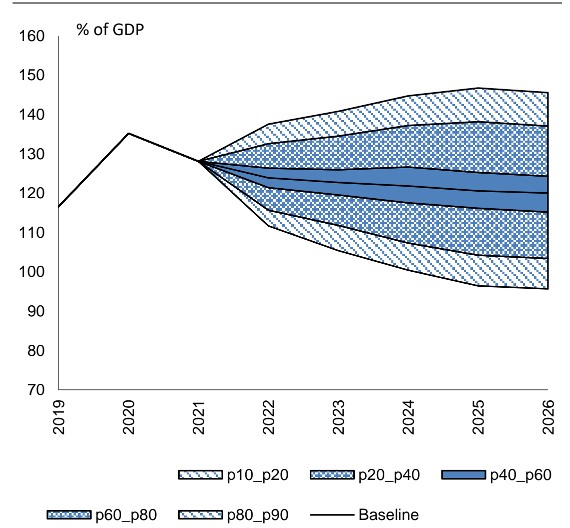
Portugal's debt-to-GDP ratio remains sensitive to a worsening of the country's economic and financing conditions. In an alternative 'financial stress' scenario – whereby market interest rates would be assumed to increase temporarily by at least 1 pp. in 2022 ([16]) – the path of the public debt-to-GDP ratio is projected to persistently shift upwards by slightly above 1 pp. of GDP over the projection horizon, as compared to the Commission's baseline scenario. In turn, in an 'adverse interest-growth rate differential' scenario – whereby that differential would be assumed to increase 1 pp. by applying simultaneous unfavourable shocks to (short and long-term) market interest rates and GDP growth – the ensuing worsened macro-financial conditions would drive the public debt-to-GDP ratio to exceed its observed peak at the end of 2020, thereby attaining a new maximum in 2032. This adverse scenario illustrates the risk of a reversal of Portugal's favourable interest-growth rate differential.

Graph A1.1: **Public debt projections under different scenarios for GDP growth and interest rates**



Source: European Commission

Graph A1.2: **Stochastic projections for the public debt-to-GDP ratio in the period 2021-2026**



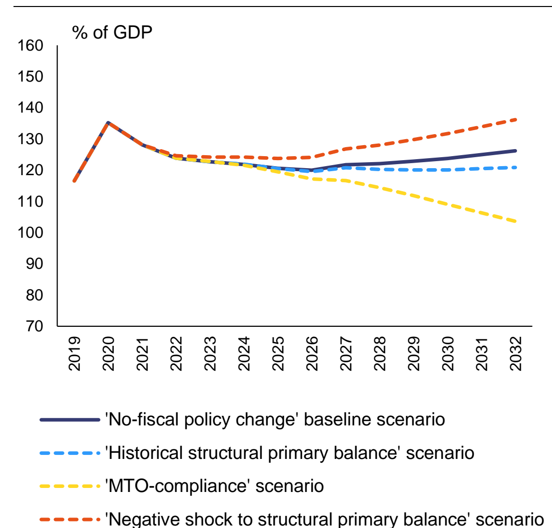
Source: European Commission

([16]) For highly indebted countries such as Portugal, the adverse shock on market interest rates by 1 pp. in 2022 is aggravated by a 'risk premium', linked to the debt level in excess of 110% of GDP. After one year, market interest rates would return to the standard assumption, but the repercussion on the implicit interest rate would persist over time, in line with the composition of public debt.

The sensitivity of Portugal's public debt-to-GDP ratio to shocks is also evident based on stochastic projections. A stochastic extension of the Commission's baseline projection based on the historical volatility of the Portuguese economy shows that the public debt projections are surrounded by considerable uncertainty (see Graph A1.2). ([17]) According to the resulting stochastic projections, there is a possibility that the public debt-to-GDP ratio will not attain a decreasing path over the next five years, thereby reaching an even higher level by 2026, as compared to 2020.

The refocusing of fiscal policies towards achieving prudent medium-term fiscal positions, when appropriate, remains critical. In an alternative 'historical structural primary balance' scenario – whereby the structural primary balance would converge to its latest 15-year historical average of a broadly balanced budget in structural terms – the public debt-to-GDP ratio would settle at around 120% by 2026 (see Graph A1.3). Importantly, in a 'medium-term objective compliance' scenario – whereby Portugal would be assumed to implement the provisions of the Stability and Growth Pact over the projection horizon ([18]) – the country's public debt-to-GDP ratio would be projected to be on a steadily downward path, reaching around 105% by 2032, more than 20 pps. beneath the Commission's baseline scenario and clearly below its pre-crisis level. In contrast, in a scenario incorporating a negative shock to the structural primary balance – whereby it would be assumed to improve by only half of the projected cumulative change over the forecast years ([19]) – the decrease of the public debt-to-GDP ratio would be reversed as of 2027, while remaining persistently above 120% over the projection horizon.

Graph A1.3: **Public debt projections under different scenarios for fiscal consolidation**



Source: European Commission

In spite of the aforementioned risks to fiscal sustainability in the medium term, the dynamics of Portugal's public debt benefits from relevant mitigating factors. These factors notably relate to Portugal's solid cash buffer (see Section 5), the country's relatively stable financing sources – with a diversified and large investors' base – and the observed gradual smoothening of the redemption profile of its public debt. Furthermore, the growth-friendly impact of Next Generation EU, including the investments under the Recovery and Resilience Facility, is expected to yield a substantial positive and long-lasting impact on GDP growth in the coming years. Combined with the implementation of prudent fiscal policies, these would usefully contribute to strengthening the sustainability and resilience of Portugal's public finances in the medium term.

([17]) Stochastic debt projections allow assessing the uncertainty surrounding macroeconomic and fiscal projections. Projections have a five-year projection horizon. Results are based on 80% of all possible debt paths obtained by simulating 2,000 shocks to the primary balance, nominal growth and interest rates (the lower and upper lines delimiting the cone represent respectively the 10th and the 90th distribution percentiles). In the graph, the projected public debt path under the baseline (around which shocks apply) is reported as a solid black line at the centre of the cone. The differently shaded areas within the cone represent different portions of the distribution of possible debt paths. The dark blue area (delimited by the 40th and the 60th percentiles) includes the 20% of all possible debt paths that are closer to the baseline.

([18]) Operationally, after the headline deficit has been brought to 3% of GDP, Portugal is assumed to converge as from 2023 to its medium-term objective (MTO) and to keep its structural balance constant at the MTO once it is achieved.

([19]) This scenario implies that the forecast structural primary balance deficit would be assumed to be larger, and then remain constant at this higher level as of 2023. This scenario incorporates a feedback effect on GDP growth on the basis of fiscal multiplier of 0.75.

ANNEX 2

European Commission macroeconomic and fiscal projections

Table 1: Use and supply of goods and services (volume)

Annual % change	**2020**	**2021**	**2022**	**2023**
1. Private consumption expenditure	-7.1	4.6	4.2	2.4
2. Government consumption expenditure	0.4	4.5	2.0	0.5
3. Gross fixed capital formation	-2.7	5.4	5.2	4.3
4. Final domestic demand	**-5.0**	**4.7**	**4.0**	**2.4**
5. Change in inventories	--	--	--	--
6. Domestic demand	**-5.5**	**4.6**	**4.0**	**2.4**
7. Exports of goods and services	-18.8	11.1	9.5	4.0
7a. - of which goods	-7.8	9.6	3.6	2.9
7b. - of which services	-36.9	14.5	23.5	6.0
8. Final demand	**-9.6**	**6.3**	**5.6**	**2.9**
9. Imports of goods and services	-12.1	10.9	6.2	4.1
9a. - of which goods	-9.4	10.8	4.7	3.9
9b. - of which services	-23.7	11.3	13.8	5.0
10. Gross domestic product at market prices	**-8.4**	**4.5**	**5.3**	**2.4**
Contribution to change in GDP				
11. Final domestic demand	-5.0	4.8	4.1	2.4
12. Change in inventories + net acq. of valuables	-0.6	-0.1	0.0	0.0
13. External balance of goods and services	-3.0	-0.2	1.2	-0.1

Table 2: Use and supply of goods and services (value)

Annual % change	**2020**	**2021**	**2022**	**2023**
1. Private consumption expenditure	-6.4	5.8	6.1	3.8
2. Government consumption expenditure	5.1	5.9	3.1	1.5
3. Gross fixed capital formation	-1.6	7.9	7.7	6.5
4. Final domestic demand	**-3.6**	**6.2**	**5.9**	**3.9**
5. Change in inventories	--	--	--	--
6. Domestic demand	**-4.3**	**6.1**	**5.9**	**3.9**
7. Exports of goods and services	-20.6	14.7	11.9	5.3
8. Final demand	**-9.2**	**8.4**	**7.6**	**4.3**
9. Imports of goods and services	-15.1	15.4	8.5	5.4
10. Gross national income at market prices	-5.7	6.1	6.6	3.9
11. Gross value added at basic prices	-6.1	5.7	7.3	3.8
12. Gross domestic product at market prices	**-6.7**	**5.6**	**7.2**	**3.8**
Nominal GDP, EUR bn	200.1	211.3	226.5	235.1

Table 3: Implicit price deflators

% change in implicit price deflator	2020	2021	2022	2023
1. Private consumption expenditure	0.7	1.2	1.8	1.4
2. Government consumption expenditure	4.7	1.3	1.1	1.0
3. Gross fixed capital formation	1.1	2.4	2.4	2.1
4. Domestic demand (incl. inventories)	**1.4**	**1.4**	**1.8**	**1.5**
5. Exports of goods and services	-2.2	3.3	2.1	1.3
6. Final demand	**0.4**	**2.0**	**1.9**	**1.4**
7. Imports of goods and services	-3.4	4.1	2.2	1.3
8. Gross domestic product at market prices	**1.9**	**1.0**	**1.8**	**1.4**
HICP	**-0.1**	**0.8**	**1.7**	**1.2**

Table 4: Labour market and cost

Annual % change	2020	2021	2022	2023
1. Labour productivity (real GDP per employee)	-6.7	2.7	4.5	1.9
2. Compensation of employees per head	2.0	2.2	3.0	3.0
3. Unit labour costs	**7.9**	**-0.6**	**-1.6**	**1.1**
4. Total population	0.1	0.1	0.1	0.1
5. Population of working age (15-74 years)	0.2	0.1	0.1	0.1
6. Total employment (fulltime equivalent)	0.8	-1.7	1.0	1.2
7. Calculated unemployment rate - Eurostat definition (%)	**6.5**	**6.9**	**6.8**	**6.5**

Table 5: External balance

levels, EUR bn	2020	2021	2022	2023
1. Exports of goods (fob)	52.1	59.6	63.1	65.8
2. Imports of goods (fob)	65.0	75.3	80.7	84.9
3. Trade balance (goods, fob/fob) (1-2)	**-12.9**	**-15.8**	**-17.6**	**-19.1**
3a. p.m. (3) as % of GDP	**-6.4**	**-7.5**	**-7.8**	**-8.1**
4. Exports of services	22.0	25.4	32.0	34.4
5. Imports of services	13.3	15.1	17.4	18.5
6. Services balance (4-5)	**8.7**	**10.4**	**14.6**	**15.9**
6a. p.m. 6 as % of GDP	**4.3**	**4.9**	**6.4**	**6.8**
7. External balance of goods & services (3+6)	**-4.2**	**-5.4**	**-3.0**	**-3.3**
7a. p.m. 7 as % of GDP	**-2.1**	**-2.5**	**-1.3**	**-1.4**
8. Balance of primary incomes and current transfers	1.8	3.4	2.2	2.3
8a. - of which, balance of primary income	-3.2	-2.4	-3.8	-3.8
8b. - of which, net current Transfers	5.0	5.8	6.0	6.1
8c. p.m. 8 as % of GDP	0.9	1.6	1.0	1.0
9. Current external balance (7+8)	**-2.4**	**-2.0**	**-0.8**	**-1.0**
9a. p.m. 9 as % of GDP	**-1.2**	**-0.9**	**-0.4**	**-0.4**
10. Net capital transactions	2.2	2.6	3.1	3.8
11. Net lending (+)/ net borrowing (-) (9+10)	**-0.2**	**0.6**	**2.3**	**2.8**
11a. p.m. 11 as % of GDP	**-0.1**	**0.3**	**1.0**	**1.2**

Table 6: Fiscal accounts

	2020	2021	2022	2023
% of GDP				
Taxes on production and imports	14.6	14.5	14.4	14.3
Current taxes on income, wealth, etc.	10.1	9.8	9.5	9.6
Social contributions	12.8	12.6	12.2	12.2
Sales and other current revenue	5.7	6.4	5.9	5.5
Total current revenue	**43.2**	**43.3**	**42.0**	**41.7**
Capital transfers received	0.3	1.3	1.2	1.2
Total revenue	**43.5**	**44.6**	**43.2**	**42.9**
Compensation of employees	12.0	11.9	11.5	11.4
Intermediate consumption	5.7	5.8	5.7	5.4
Social transfers in kind via market producers	2.1	2.1	2.0	2.0
Social transfers other than in kind	18.0	17.7	16.9	16.9
Social payments	20.1	19.9	18.9	18.8
Interest paid	2.9	2.6	2.3	2.2
Subsidies	1.8	2.1	0.5	0.5
Other current expenditure	2.5	2.5	2.7	2.5
Total current expenditure	**45.0**	**44.9**	**41.6**	**40.9**
Gross fixed capital formation	2.2	2.5	3.0	3.5
Other capital expenditure	2.1	1.7	2.0	1.3
Other (residual)	4.6	4.2	4.7	3.8
Interest expenditure	2.9	2.6	2.3	2.2
Total expenditure	**49.3**	**49.1**	**46.6**	**45.6**
General government balance (ESA2010)	**-5.8**	**-4.5**	**-3.4**	**-2.8**
Primary balance	-2.9	-1.9	-1.1	-0.5
% change				
Taxes on production and imports	-9.1	4.8	6.3	3.6
Current taxes on income, wealth, etc.	-3.7	2.7	4.4	5.2
Social contributions	1.0	4.0	3.8	3.5
Sales and other current revenue	-8.5	43.5	-1.9	-7.8
Total current revenue	**-4.5**	**5.9**	**4.0**	**2.9**
Capital transfers received	-15.9	292.6	2.3	2.7
Total revenue	**-4.6**	**8.2**	**4.0**	**2.9**
Compensation of employees	3.4	5.1	3.2	3.5
Intermediate consumption	2.6	8.5	4.6	-1.1
Social transfers in kind via market producers	1.2	7.3	2.2	1.3
Social transfers other than in kind	4.2	3.9	1.9	3.8
Interest paid	-8.4	-4.9	-5.3	1.0
Social payments	3.8	4.2	1.9	3.5
Subsidies	298.6	23.7	-72.9	-13.2
Other current expenditure	6.4	6.8	16.1	-4.0
Total current expenditure	**6.0**	**5.4**	**-0.6**	**2.0**
Gross fixed capital formation	14.0	17.4	30.4	19.9
Other capital expenditure	96.1	-15.2	24.3	-33.7
Total expenditure	**8.5**	**5.0**	**1.9**	**1.6**
Nominal GDP, EUR bn	**200.1**	**211.3**	**226.5**	**235.1**

Table 7: Government debt developments

	2020	2021	2022	2023
ESA2010 government balance (% of GDP)	**-5.8**	**-4.5**	**-3.4**	**-2.8**
ESA2010 gross debt (% of GDP)	135.2	128.1	123.9	122.7
ESA2010 government balance	**-11.7**	**-9.5**	**-7.6**	**-6.5**
Gross debt	270.5	270.8	280.6	288.5
Change in gross debt	20.5	0.3	9.8	8.0
Nominal GDP	200.1	211.3	226.5	235.1
Real GDP growth (% change)	**-8.4**	**4.5**	**5.3**	**2.4**
Change in gross debt (% of GDP)	10.3	0.1	4.3	3.4
Stock-flow adjustments (% of GDP)	4.4	-4.3	0.9	0.6
Gross debt ratio	**135.2**	**128.1**	**123.9**	**122.7**
Change in gross debt ratio	18.6	-7.0	-4.3	-1.2
Primary balance	-2.9	-1.9	-1.1	-0.5
"Snow-ball" effect	11.0	-4.5	-6.2	-2.3
of which				
Interest expenditure	*2.9*	*2.6*	*2.3*	*2.2*
Real growth effect	*10.5*	*-5.8*	*-6.4*	*-2.8*
Inflation effect	*-2.4*	*-1.3*	*-2.1*	*-1.7*
Stock-flow adjustments	**4.4**	**-4.3**	**0.9**	**0.6**
Implicit interest rate	*2.3*	*2.0*	*1.9*	*1.9*

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