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Post-Programme Surveillance Report

Portugal, Autumn 2023

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Institutional Paper 266

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This Post-Programme Surveillance assessment was prepared in the Directorate General Economic and Financial Affairs under the guidance of Declan Costello, Deputy Director General, Isabel Grilo, Director, and Florian Wöhlbier, Head of Unit for Portugal ([1]).

Contributors:

Radoslav Krastev, Leopoldo Miotto, Ana Seco Justo from the Directorate General Economic and Financial Affairs, and Michal Strojwas from the Directorate General for Financial Stability, Financial Services, and Capital Markets. Assistance was provided by Hélène Gaston.

The report was prepared in liaison with staff from the ECB ([2]). Staff from the European Stability Mechanism (ESM) also provided comments.

This report reflects information available and policy developments that have taken place until 31 October 2023. Therefore, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 autumn forecast released on 15 November 2023 (with cut-off date 31 October 2023).

Comments on the report would be gratefully received and should be sent, by mail or e-mail to:

Florian Wöhlbier

European Commission

Head of Unit responsible for Denmark, Ireland, and Portugal

CHAR 10/173

B-1049 Brussels

E-mail: florian.woehlbier@ec.europa.eu

([1]) The executive summary of this report was adopted as Commission Communication C(2023)9801 on 19 December 2023. The rest of the report reflects the findings of the Staff Working Document (SWD(2023)981) 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
CA	Current account
CET1	Common equity tier 1
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
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
RRP	Recovery and resilience plan
SMEs	Small- and medium-sized enterprises
SOEs	State-owned enterprises
VAT	Value-added Tax
y-o-y	Year-on-year

EXECUTIVE SUMMARY

The 18th post-programme surveillance (PPS) mission to Portugal took place during 18-19 September 2023. *This mission involved European Commission staff in liaison with European Central Bank (ECB) staff. European Stability Mechanism (ESM) staff participated on aspects relating to the ESM's Early Warning System.*

Portugal's economic growth slowed from 6.8% in 2022 to 2.5% (y-o-y) in the first half of 2023. *In quarterly terms, growth surprised on the upside in the first quarter of the year but weakened substantially afterwards. Overall, full-year GDP growth is expected to continue outperforming the euro area average at 1.3% in 2023 and 1.8% in 2024. Exports of services, particularly tourism, are seen as the main growth driver in 2023 while domestic demand is expected to gradually gain importance in the following years. The labour market remained robust as both labour supply and employment continued to exceed expectations and unemployment returned to a downward path. Inflation meanwhile moderated for three consecutive quarters in 2023, helped by a downward correction in energy prices. Inflation is set to moderate further over the forecast horizon. The overall balance of risks to the economic performance remains on the downside, reflecting significant geopolitical risks and uncertainty.*

Portugal's general government balance is forecast to turn into a surplus in 2023. *It is expected to reach a surplus of 0.8% of GDP in 2023, an improvement from the deficit of 0.3% of GDP recorded in 2022. The general government balance is expected to narrow in 2024 and 2025, to 0.1% and 0.0% of GDP, respectively, following the projected deceleration in government revenue alongside a steady expansion in expenditure. Portugal's public debt-to-GDP ratio is expected to continue declining in 2023, down by 9.0 percentage points of GDP, to 103.4%. This reduction pace is expected to slow down in 2024 and 2025, amid the projected moderation in inflation and narrowing of the budgetary balance. Risks to the fiscal outlook are tilted to the downside, related to general macroeconomic risks and, among others, ongoing requests for a financial rebalancing of public-private partnerships (PPPs). Steps are being undertaken to improve the quality and sustainability of Portugal's public finances, with key fiscal-structural reforms embedded in the country's recovery and resilience plan.*

Portugal's banks continued to improve their performance in terms of profitability and capitalisation. *Moreover, local lenders operated with high liquidity in the first half of 2023 and a level of non-performing loans that is close to its lowest in a decade, despite some recent signs of deterioration in the credit quality of mortgages. This makes the sector less sensitive to shocks than in the past. Nevertheless, risks to financial stability remain in light of the uncertain external environment and high interest rates, including the high exposure of households to variable interest rates. However, despite the challenging environment, the banking sector is resilient. Risks are also partly offset by government policy measures aimed at mitigating the increase in the interest rate burden of households.*

Portugal retains the capacity to service its debt. *Despite a number of challenges, the economic, fiscal and financial situation in Portugal is overall stable. According to the Commission's debt sustainability analysis, medium-term risks to Portugal's fiscal sustainability are high overall, but low in the short- and long-term. Financing needs are expected to decrease in 2023. An EFSM maturity is scheduled for the end of 2023, and the next EFSF loan repayment is planned for 2025. Financial market perceptions of Portugal's sovereign debt remain favourable, with its rating or outlook having been upgraded by the four main rating agencies in 2023.*

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1. INTRODUCTION

From mid-2011 until mid-2014 Portugal implemented an economic adjustment programme with the European Union and the International Monetary Fund (IMF). The overall financial package was agreed at EUR 78 billon. In June 2014, Portugal exited the programme.

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the eighteenth post-programme surveillance (PPS) mission to Portugal during 18-19 September 2023. Staff from the European Stability Mechanism (ESM) participated in the meetings on aspects related to the ESM's Early Warning System. IMF staff also participated in the meetings. Under PPS, the Commission carries out regular review missions to EU Member States that have had an EU-supported financial assistance programme. The objective of the PPS missions is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt. ([3])

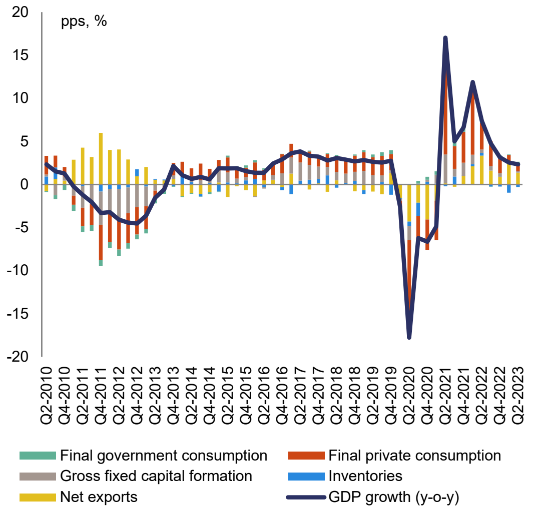
This report reflects information available and policy developments that have taken place until 31 October 2023. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 autumn forecast released on 15 November 2023 (with cut-off date 31 October 2023).

([3]) Under Regulation (EU) N°472/2013, PPS will continue until at least until 75% of the financial assistance received under the programme has been repaid. Under the current repayment schedule, PPS on Portugal will last until 2035.

2. ECONOMIC DEVELOPMENTS

Following strong growth of 6.8% in 2022, Portugal's economy expectedly decelerated in the first half of 2023. In y-o-y terms, growth slowed to 2.5% and 2.6% in the first and second quarters of 2023, respectively. In q-o-q terms, the high growth rate of 1.5% in the first quarter plunged to 0.1% in the second quarter due to a contraction in private consumption, investment, and exports of goods. Export of services, particularly tourism, continued to contribute considerably to growth albeit at a somewhat diminishing rate. Government consumption also increased in the second quarter after a small decline in the first quarter.

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



Source: Portugal's National Statistical Office (INE).

Growth is set to deteriorate further in annualised terms in the second half of 2023. A substantial weakening in external demand as well as increased interest expenditure of households and companies continued to weigh negatively on the economy in the third quarter of the year. While economic sentiment dropped below the long-term average in the third quarter of 2023, preliminary estimates pointed to certain recovery in private consumption and investment. Tourism continued to expand at a weaker pace in the summer months, as compared with the beginning of the year, but daily flight statistics signalled a slight re-acceleration in October. Overall, high frequency indicators point to a benign performance in the second half of the year.

In full-year terms, the economic slowdown is expected to continue in 2024. Taking into account the flash GDP estimate of -0.2% (q-o-q) for the third quarter of 2023, full-year GDP growth is projected at 2.2% in 2023. In 2024, growth is forecast to further moderate to 1.3%. However, growth is projected to gradually pick up in quarterly terms over the forecast horizon, supported by a recovery of domestic demand and global trade. On the side of private consumption, the increase in real wages and employment is set to outweigh the negative impact of higher interest rates, which are assumed to flatten over the forecast horizon. At the same time, investment is projected to benefit substantially from the implementation of the Recovery and Resilience Plan (RRP) and other EU-funded projects.

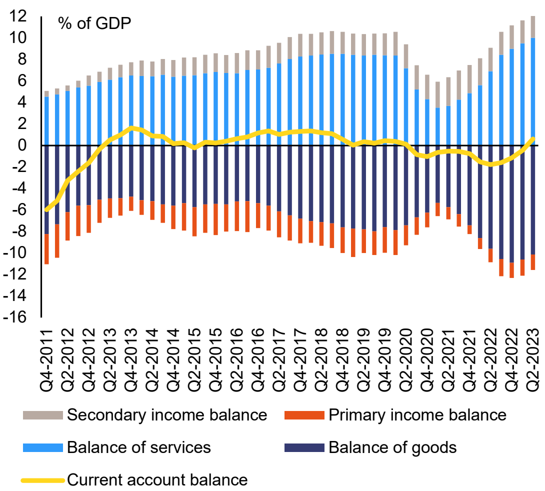
The balance of risks to Portugal's growth outlook remains on the downside. This reflects significant global risks and uncertainty in the external environment, including the high volatility in commodity prices. Country-specific risks are mainly linked to the high share of variable interest rates for housing loans and their potential impact on households' consumption. However, this risk is partly offset by government support measures aimed at smoothening the debt repayment profile of households, allocation of interest rate subsidies to vulnerable households and incentives for renegotiation of loans (see Section 4 on financial sector developments).

The current account is turning positive helped by tourism and price effects. The current account balance turned from a deficit of 1.1% of GDP in 2022 to a surplus of 0.6% of GDP in annualised terms as of mid-2023 (the 12-month period ending in June 2023). The trade balance benefited substantially from the decline in energy prices and reduced demand for natural gas in the power generation sector where the recovery in the water reservoirs increased hydropower generation. The balance in services also improved substantially, reflecting strong growth in foreign tourism, both in volume and price terms. In the first half of 2023, export of services surged by 26.5% y-o-y in nominal terms and 51.7% in relation to the corresponding period of the last pre-pandemic year of 2019. In volume terms, the growth rates were 19.1% and 25.0%, respectively. Net exports of services reached 11.2% of GDP in the first half of

2023 relative to 8.4% and 8.3% in the corresponding periods of 2022 and 2019.

The current account surplus is projected to improve further in the second half of 2023 as the price effects will remain favourable in annualised terms. In addition, tourism has a very large seasonal impact on the current account balance in the third quarter of the year. In the following two years, the surplus is projected to decrease somewhat as the price effects are set to fade away while the expected growth in domestic demand is set to push up import volumes.

Graph 2.2: **Current account balance**

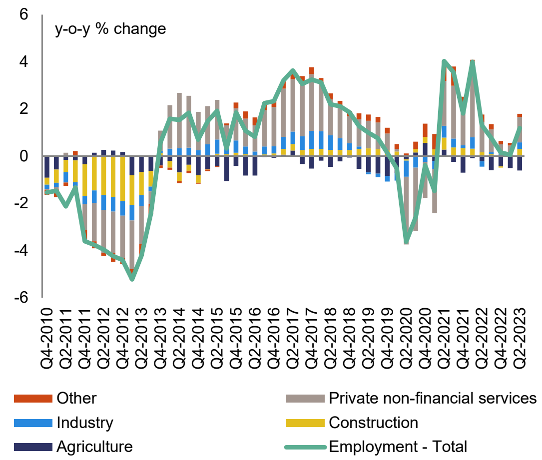


Source: Banco de Portugal.

Portugal's net international investment position (NIIP) continues to improve at a fast pace. The positive trade flows contributed to a further reduction in the stock of Portugal's net external liabilities. The NIIP share in GDP improved from -83.6% at the end of 2022 to -76.9% as of end-June 2023, following substantial improvements in previous years (-100% in 2019). The NIIP ratio also benefited from the strong rise in nominal GDP and positive valuation effects.

The labour market remains robust. Despite the observed economic slowdown, labour market indicators continued to strengthen. After a temporary increase to 7.0% in January 2023, unemployment moved back on a downward path reaching 6.3% in August. The average unemployment rate for January-August 2023 is estimated at 6.6%. Meanwhile, employment growth increased from rates close to zero at the beginning of 2023 to 1.3% (y-o-y) in the summer months. The employment rate for the age group of 16-74 years-old reached a new historic high of 64.3% in July and August, following continuous record breaks in the past two years. Labour supply also continued to improve at a strong pace on the account of a substantial rise in the national register of foreign-residence workers. The impact of net migration is also seen from the labour force statistics where the population in the age group of 16-74 years-old rose by 0.4% (y-o-y) in January-August 2023.

Graph 2.3: **Employment evolution by sectors**



Source: Eurostat.

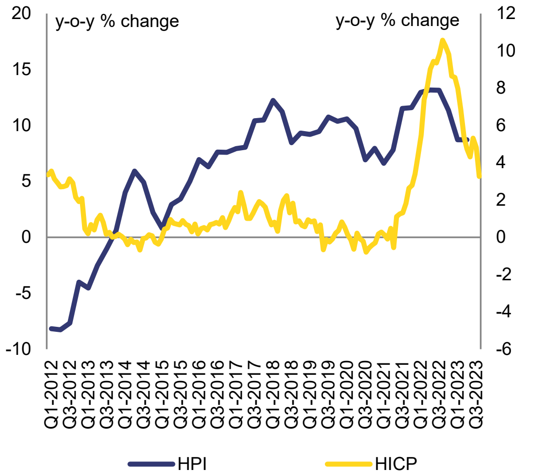
Recent job creation is driven by temporary factors related to tourism as well as sectors with higher skill requirements. A large proportion of the job creation in the summer months came from temporary contracts, indicating that some of the improvement was driven by seasonal activities related to tourism. Although the headline monthly statistics are seasonally adjusted, the exceptional rebound in tourism was still having a strong positive impact on the labour market indicators. The sectoral breakdown for the second quarter of 2023 shows that employment in tourism, construction and administrative services increased the most relative to a year earlier. Compared to the pre-pandemic period, the largest expansion is reported in the sector of information and communication activities, while the share of temporary employment has decreased.

Employment growth is expected to moderate. In line with the projected economic slowdown and moderation in tourism and related labour-intensive services, employment growth is projected to weaken towards the end of 2023 and in 2024. Accordingly, unemployment is set to stabilise in annual-average terms over the forecast horizon. While labour demand is expected to moderate and labour supply is supported by net migration, some sectors are still likely to face tight hiring conditions and wage pressures.

Inflation moderated in the third quarter of 2023. HICP inflation decreased for the third quarter in a row, to 4.8% (y-o-y) in 2023-Q3 from a peak of 10.2% in 2022-Q4. Inflation excluding energy and unprocessed food also followed a downward trend, but at a slower pace, reaching 6.0% (y-o-y) in 2023-Q3. Services prices, particularly accommodation, were the major inflationary driver reflecting the surge in foreign tourism visits as well as the rise in nominal wages. While domestic private consumption was subdued, the wage increases affected prices mostly through cost pressures on companies. Energy prices continued to decline in annualised terms in 2023-Q3 but the reversal in fuel prices in August, reflecting regulatory effects and crude oil fluctuations, weakened their disinflationary impact.

Inflation is set to further moderate in 2024-2025. Taking into account the recent dynamics in commodity prices and the Commission energy price assumptions over the short-term forecast horizon, headline inflation is set to continue to moderate. The strong growth in the average wage, reported at 7.2% (y-o-y) in 2023-Q2, is projected to keep some pressure on services prices in the short term. Consequently, inflation excluding energy and unprocessed food is projected to moderate at a slower pace than the headline rate.

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



Source: Eurostat.

House prices keep growing at a high rate despite weaker transaction volumes. House prices increased by 8.7% (y-o-y) in both the first and second quarters of 2023, decelerating from an annual average growth of 12.6% in 2022. The deflated house price index, adjusted for the private consumption deflator, increased by 0.5% and 3.6% respectively, down from an annual average of 4.8% in 2022. Meanwhile, transaction volumes dropped significantly, by 22.9% (y-o-y) in 2023-Q2, reflecting the impact of rising interest rates on housing loans. Transactions with non-residents dropped at a lower rate of 8.9% for the same period and accounted for 7.5% of the total. Although house prices are projected to grow at a slower pace in the short term, a strong correction in price levels is not expected at this stage, considering the limited volumes of new construction and the assumed stabilisation of interest rates.

3. PUBLIC FINANCE DEVELOPMENTS

3.1. FISCAL PERFORMANCE AND OUTLOOK

Portugal's general government balance is forecast to turn into a surplus in 2023. The general government balance recorded a deficit of 0.3% of GDP in 2022. According to the Commission 2023 autumn forecast, which incorporates the information available in the Portuguese 2024 Draft Budgetary Plan (DBP), the general government balance is expected to improve markedly, reaching a surplus of 0.8% of GDP in 2023. The government revenue dynamism observed for 2022 is expected to have continued in 2023, supported by the robust labour market, expected wage increases, and the still high inflation. The expansion of government expenditure is, on the other hand, projected to be contained, driven by the complete phase-out of COVID-19 temporary emergency measures and the reduced net budgetary impact of energy support measures. Interest expenditure is projected to increase only by approximately 0.1 percentage points of GDP in 2023. Public investment is projected to continue to expand this year, driven by the implementation of the RRP and other EU-funded programmes.

The general government balance is expected to narrow in 2024 and 2025. According to the Commission 2023 autumn forecast, the general government balance is expected to contract in both 2024 and 2025, to 0.1% and 0.0% of GDP, respectively. The projected economic slowdown, alongside with the expected moderation in inflation, is expected to translate into a deceleration in government revenue. At the same time, government expenditure is projected to continue to expand. The public wage bill and social transfers are expected to continue exerting upward pressure on government current spending over the forecast horizon. The tightening of financing conditions is set to lead to a limited increase in interest expenditure in 2024 and 2025 (see Section 5). Public investment is set to be sustained over the forecast horizon, above the projected level for 2023.

Portugal's public debt-to-GDP ratio is projected to continue declining over the forecast horizon, although at a slowing pace. From the 112.4% recorded for 2022, already below pre-pandemic levels, the public debt-to-GDP ratio is forecast to decrease by 9.0 percentage points of GDP, to 103.4% of GDP in 2023. The Commission 2023 autumn forecast projects a slowdown in the pace of debt reduction, with the ratio contracting to 100.3% in 2024 and 97.2% in 2025. The main drivers for these developments are the projected primary surpluses and the favourable snowball effects (the combined impact of interest payments and nominal GDP growth on the debt dynamics). Both factors are forecast to have a more pronounced debt-reducing effect in 2023, and to ease in 2024 and 2025, in tune with the projected narrowing of the general government balance, the limited increase in interest expenditure and the expected moderation in inflation. On the other side, the stock-flow adjustment (reflecting the difference between the change in debt and deficit) is expected to contribute with a debt-increasing effect over the forecast horizon (see Annex 2 on the Commission's debt sustainability analysis).

Risks to the fiscal outlook are tilted to the downside. The global and country-specific risks identified for Portugal's macroeconomic outlook (see Section 1) are also risk factors to the fiscal outlook. More specifically for Portugal's public finances, risks relate, among others, to ongoing requests for a financial rebalancing of public-private partnerships (PPPs), including those related to the impact of COVID-19 on their activities, and vulnerabilities in some public corporations. The more frequent and intense natural hazards faced by Portugal, also represent a relevant risk to the country's fiscal outlook ([4]).

3.2. POLICY ISSUES

Steps are being undertaken on the quality and sustainability of Portugal's public finances. The Portuguese RRP includes measures to strengthen Portugal's framework for fiscal policy. It contributes to deliver on the full and effective implementation of the 2015 Budgetary Framework Law, to make spending reviews part of the country's annual budgetary cycle, and to reinforce the integration between public revenue and

([4]) See European Commission Staff Working Document of 24 May 2023, '2023 Country Report for Portugal' (SWD(2023) 622 final).

expenditure management, with improvements in the remit of centralised procurement, the introduction of programme budgeting and adherence to accruals-based accounting. The modified RRP for Portugal ([5]) includes a new reform to improve the effectiveness of Portugal's tax system. This new reform, with a timeline of by second quarter of 2026, consists of the creation of a permanent technical tax policy unit, with the mandate to systematically monitor and evaluate new and existing tax benefits, as well as to proceed with the revision of the legal framework for selected tax benefits. Moreover, Portugal formally set up a working group for spending reviews ([6]).

After the impact of COVID-19, the financial sustainability of the health system shows first signs of improvement. Preliminary data for 2022 points to a lower deficit of the National Health System (NHS) of 0.4% of GDP, from a 0.6% of GDP in 2021. For 2023, according to the authorities' estimates, the NHS balance is projected to further improve to a deficit of 0.3% of GDP. As per the nature of the NHS, own resource revenues are limited, with its balance developments mainly influenced by the current transfers from the State Budget. Current transfers from the State budget to the NHS were equal to 4.8% of GDP in 2022 and are expected to increase by EUR 1.2 billion to EUR 12.7 billion in 2023, EUR 0.4 billion higher than initially planned in the 2023 Portuguese State Budget. On the expenditure side, upward pressures on NHS spending on wages, medicines, and medical services, persist. The level of NHS financial arrears decreased by the end of the second quarter of 2023, as compared with the same quarter of the previous year, by approximately EUR 195 million, reaching EUR 417 million. The developments in financial arrears reflect coverage granted by additional State budget transfers.

The financial situation of the state-owned enterprise (SOE) sector is stabilising, although vulnerabilities remain. The financial situation of SOEs improved in 2022, in line with the recovery of economic activity after the impact of COVID-19. During the first half of 2023, this improvement appears to be confirmed. Preliminary data for this period, as compared with the first half of 2022, points to an increase in SOEs revenues, with higher turnover, which more than compensated the increase in operational expenditure, mainly related to higher input costs. Overall, SOEs negative net income appears to have improved slightly by the end of the second half of 2023. Nonetheless, financial vulnerabilities within the sector persist. Debt of non-financial SOEs remains elevated, reaching approximately EUR 19 billion by the end of the first half of 2023. For PPPs, outturn data points to a decrease in net payments for the first half of 2023, mainly related to PPPs operating in the motorway and the health sector. Going forward, a decrease in outstanding PPPs' net payments is expected, related to the end of current contracts and projected revenue increases. Financial rebalancing requests related to the impact of COVID-19 on PPPs are still under assessment or discussion.

([5]) Council Implementing Decision of 17 October 2023 (ST 13351/23+ADD 1 REV 1) on the approval of the assessment of the modified recovery and resilience plan for Portugal.

([6]) Order of the Minister of Finance No 7690/2023 of 25 July published in the Portuguese Official Journal ('*Diário da República*'), No 143/2023, second series of 25 July 2023, pages 47-49.

4. FINANCIAL SECTOR DEVELOPMENTS

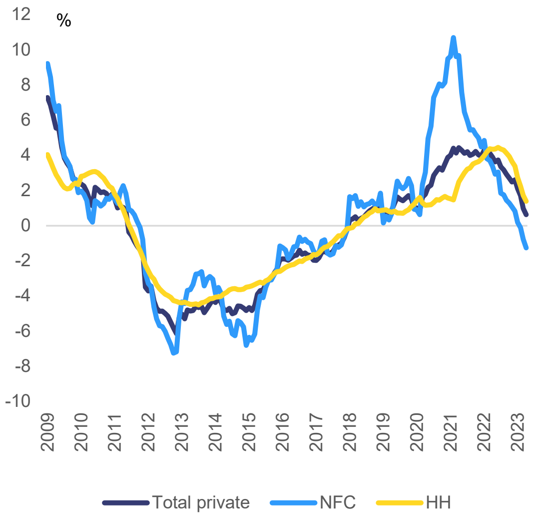
Portugal's banks continued to improve both profitability and levels of capitalisation over the past quarters. Moreover, local lenders currently operate with high liquidity and a level of NPLs that has been close to its lowest since a decade. This makes the sector less sensitive to shocks than in the past. Nevertheless, risks to financial stability remain. Geopolitical concerns continue to heighten uncertainty, while monetary policy normalisation is gradually impacting the economy and bank balance sheets. This in turn creates a set of risks to financial stability and vulnerabilities to the financial sector. The combination of high, albeit moderating, inflation and high interest rates has the potential to increase default rates of households and firms, though the Portuguese private sector is a lot less leveraged today than a decade ago. The real estate market has been very dynamic in recent years benefiting from low interest rates. Its cooling down, if substantial, may have a negative impact on the value of the collateral of loans secured by real estate. However, despite the challenging environment, the banking sector is resilient.

Portugal's banks kept improving their profitability aided by soaring interest income. Return on equity (ROE) and return on assets (ROA) both increased, and stood at 13.7% and 1.16%, respectively in June 2023[7]. The profitability improvements were mainly driven by a higher net interest margin. Credit institutions benefitted from rapidly increasing income from their large share of variable-rate loans, while expenses on customers' overnight and term deposits have recorded only a mild increase so far. Higher remunerations on central bank deposits, which steeply increased in the first half of 2023, further supported banks' interest income. On the cost side, banks reported an increase in provisions and credit impairments, as higher instalments and debt-servicing ratios increased the risk profile of some pools of borrowers. Operating costs also increased, but to a lower extent than core revenues, allowing banks to further reduce their cost-to-core-income ratio by 13.8 pps. y-o-y, to 41.4% in June 2023, well below pre-pandemic levels (of above 60% at end-2019). Looking ahead, banks expect to keep on profiting from the higher interest rate environment, as an increasing share of their loan book is being repriced at the current, higher, rates.

[7] Source: ECB and Banco de Portugal.

However, the combination of low loan generation, increasing credit risks and devaluations of some long-term securities suggest caution, even in a context of generally positive developments.

Graph 4.1: **Loans to the private sector**



(1) change y-o-y, adjusted
(2) annualised data
Source: ECB.

New lending continues its downward path. Since July 2022 interest rates have been rising at the highest pace in the history of the monetary union. The tighter financing conditions have rapidly spilled over to the credit markets resulting in higher credit costs and lower demand. For domestic non-financial corporations (NFC), the annual rate of change of bank credit has been negative since the beginning of 2023. Banks, not surprisingly, point to the level of interest rates and the reduction in firms' investment needs as main explanatory factors for lower credit demand (according to the central bank's lending survey). Households have also been much more conservative in contracting new loans as interest rates kept rising and consumer confidence declined. In particular, the demand for new mortgages decreased substantially leading to a negative net mortgage flow. In parallel, households have been increasingly eager to lock in the interest rate on mortgages. In the first half of 2023, the share of new mortgages with an interest rate fixation period above one year has grown from 23% to 49%. Loans for consumption, less sensitive to interest rate volatility, continued to rise by 6%

Table 4.1: **Soundness indicators**

	Portugal								Euro area	EU
in %	Q4-2016	Q4-2017	Q4-2018	Q4-2019	Q4-2020	Q4-2021	Q4-2022	Q1-2023	Q1-2023	Q1-2023
Non-performing loans	17.2	13.3	9.4	6.1	4.9	3.6	3.0	3.1	1.8	1.8
o/w NFC sector	29.4	25.2	18.5	12.3	9.8	8.1	6.5	6.4	3.3	3.2
o/w HH sector	8.7	7.1	5.1	3.7	3.4	2.8	2.3	2.4	2.1	2.1
Coverage ratio	45.4	49.9	52.4	51.7	55.4	52.6	55.4	56.4	45.2	44.9
Return on equity (1)	-5.5	-0.8	2.7	4.3	0.0	4.9	8.7	13.6	9.7	10.1
Return on assets (1)	-0.3	0.0	0.3	0.5	0.0	0.4	0.7	1.2	0.7	0.7
Total capital ratio	12.3	15.2	15.2	16.7	18.1	18.0	18.1	18.4	19.3	19.4
CET 1 ratio	11.4	13.9	13.2	14.1	15.4	15.5	15.3	15.6	15.8	16.0

(1) Annualised data.

Source: ECB, own calculations.

y-o-y in June 2023, and demand was relatively steady, according to the lending survey.

Banks' asset quality remained resilient, despite a slight uptick in NPLs. Both households and NFCs withstood well the gradual rise in interest rates and instalments. However, increased pressure on households and a denominator effect (i.e., lower outstanding loans) translated in a slight increase of the gross NPL ratio, up from 3% at end-2022 to 3.1% in June 2023. Over the same period the NPL coverage ratio improved, increasing from 55.5% to 56.6% and keeping the share of net NPLs unchanged at 1.3%. The share of Stage 2 loans (i.e., with higher risk) also increased following a similar pattern over the first semester of 2023, from 10.3% to 10.7%. Mortgages were the main drivers of this increase, as higher debt servicing was captured in the banks' risk management models. Conversely, asset quality improved for NFC loans, with NPLs decreasing from 6.5% to 6.2% and Stage 2 loans from 16% to 14.8%. Going forward, it will remain very important for banks and supervisors to monitor closely the developments in credit quality, especially for borrowers exposed to variable rates and for NFCs in the sectors that have been more structurally impacted by the pandemic.

Banks strengthened their capital ratios and kept benefitting from high liquidity. Portuguese banks' CET1 ratio increased to 16.4% in June 2023, up by 1 pp since end-2022, above the euro area average of 15.3%. These improvements were driven by banks' withholding of profits, supported also by an overall reduction in total assets (denominator effect). The financial market turbulence of the first half of the year impacted the market demand for AT1 and other MREL-compliant instruments. Nevertheless, Portuguese banks advanced their issuance of MREL compatible instruments, and all significant institutions appear on track to meet their MREL requirements for January 2024. Banks kept benefitting from ample liquidity levels, with a liquidity coverage ratio of 218% in June 2023, even after repaying a significant share of their central bank funding. The loan-to-deposit ratio increased somewhat in the first half of 2023, rising from 78.2% to 79.6%, but it remains low by historical standards and in comparison to the euro area average. In Q1 2023, early mortgage repayments and transfers to better-remunerated saving instruments had caused a marked reduction in households' deposits. However, this trend was reverted already in the second quarter of 2023, with banks recording an increase in deposits from households. Looking forward, and notwithstanding their reassuring liquidity levels, banks are warranted to keep monitoring closely liquidity developments and changes in competition over deposits. Stable liquidity buffers will be especially important to prevent the possible materialisation of unreported losses on banks' long-term securities.

An array of temporary borrower initiatives is aimed at easing rising mortgage payments and preserving banks' balance sheets. Around 90% of the Portuguese residential mortgage stock is at variable rates. Consequently, the rapid increase in interest rates (mortgage rates rose by 360bp between end-2021 and July 2023 against an average 250bp rise in the euro area) has contributed to a strong rise in the cost of debt service for borrowers. As in the past, the risk of possible default is the highest for low-income households, additionally exacerbated by the rise in inflation and the economic slowdown. Therefore, the authorities approved, back in Q4 2022, a package of measures aimed at preventing future asset quality deterioration through encouraging banks towards a more proactive management of the clients at risk and, in Q1 2023, providing financial assistance to mortgagees that struggle with their monthly payments. An additional measure was approved in October 2023 for a period of two years. In effect, homeowners that contracted their debt before 15 March 2023 can request their bank to pay an instalment that corresponds to an underlying benchmark of 70% of the six-month Euribor rate, over a two-year timeframe. The change does not affect the loans' net present value and banks can recover the unpaid capital after four years spreading the payments until the mortgages mature.

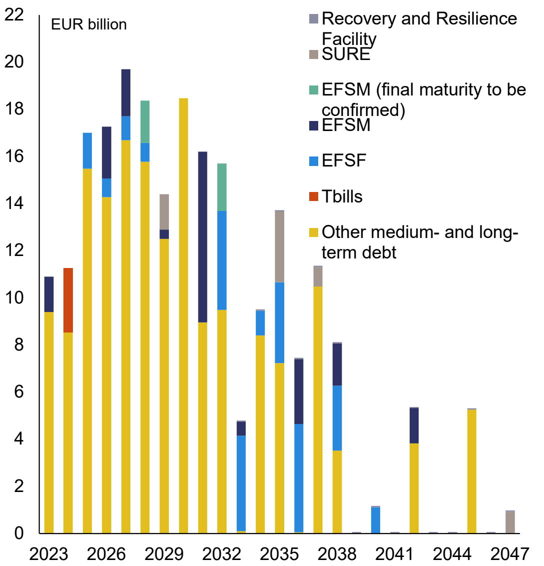
5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Financing needs are expected to decrease. Financing needs in 2023 are estimated to decrease by approximately EUR 5 billion, from EUR 24.7 billion (10.2% of GDP) in 2022. This decrease is mainly due to the expected improvement in the budget balance on a cash basis and the decrease in debt redemptions for the year. Portugal's cash buffer (as measured by general government deposits) is expected to increase by the end of 2023 to EUR 19.5 billion (7.4% of GDP), from EUR 13.9 billion in 2022 (5.7% of GDP), above Portugal's cash buffer management benchmarks.

Portugal's financing sources remain diversified, with increased issuances of retail debt. Traditional financing sources, such as Portuguese government bonds, remain the country's main debt issuance instrument. Retail debt issuances, as saving certificates ('*Certificados de Aforro*') ([8]), gained importance during the first half of 2023, with signs of a reversal of the trend for the rest of the year. Net issuances of saving certificates are expected to reach nearly EUR 11 billion in 2023, as compared with approximately only EUR 5 billion in 2022. At the same time, net issuances of T-bills are projected to decrease in 2023, reaching approximately a negative net issuance of EUR 3.3 billion, as compared with the EUR 1.3 billion of net issuances in 2022. Syndications and auctions remain the main issuance methods, alongside a revamp of private placements. The investor base is stable and diversified across regions and types, with an increased participation of central banks and other official institutions in Portuguese government bonds syndications.

The debt management office targets a smoothening of the debt redemption profile. Debt redemptions are expected to peak in the medium-term (see Graph 5.1), mainly owing to outstanding Portuguese government bonds series maturing between 2025 and 2030. As part of its debt management strategy, Portugal continued to engage in operations, such as buy-backs and government exchange offers, seeking to avoid redemption peaks and limiting refinancing risks. Notably, Portugal bought back or exchanged, by the cut-off date of this report, approximately EUR 2 billion of a Portuguese government bond, otherwise maturing in 2024, and EUR 0.5 billion, EUR 0.2 billion, and EUR 1.1 billion of government bonds maturing in 2025, 2026 and 2027, respectively. The average residual maturity of Portugal's public debt is expected to decline to 7.2 years by the end of 2023, in line with the average residual maturity by end-2022.

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



(1) Last update: 12-10-2023
Source: Portuguese Treasury and Debt Agency (IGCP).

Portugal is set to benefit from significant EU financing. On 17 October 2023, the Council endorsed the modified RRP for Portugal. With the modified plan, the overall envelope available to Portugal under the Recovery and Resilience Facility (RRF) increased by EUR 5.6 billion, to a total of EUR 22.2 billion (8.4% of GDP in 2023). This update includes the increase of non-repayable support (grants) by EUR 1.6 billion ([9]), additional

([8]) Saving certificates ('*Certificados de Aforro*') are non-tradable and retail distributed, only to be subscribed by households. The Government Order No 149/2023 of 2 June 2023 proceeded to create a new series of saving certificates, the so-called '*F series*', and to terminate the 'E series', in place since 2017 (Government Order No 329-A/2017 of 30 October). Saving certificates of the 'F series' have a maturity of 15 years, and their interest rate is calculated monthly based on the three-month Euribor rate and includes a holding premium. Their interest rate can fluctuate between 0% to 2.5%, being accrued on a quarterly basis. Early redemptions, total or partial, are possible.

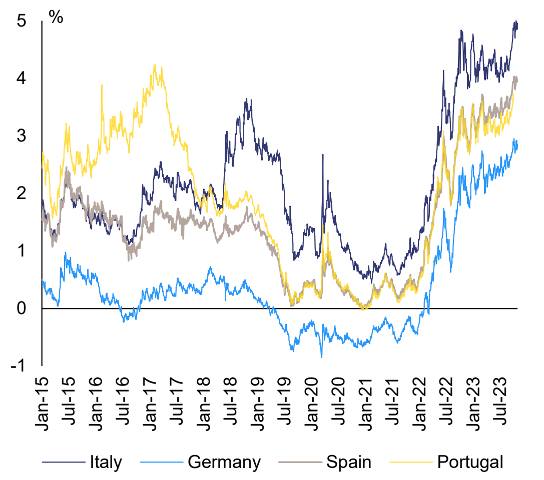
([9]) Commission note to the Council and European Parliament on 30 June 2022 relating to the update of the maximum financial contribution as stipulated in Article 11(2) of the

EUR 3.2 billion in loans, and the funds available for the investments and reforms in the REPowerEU chapter, namely the transfer from the Brexit Adjustment Reserve (EUR 81.4 million) and the revenues from the emission trading system (EUR 703.4 million). Portugal also submitted to the Commission in October 2023 a payment request for the third and fourth instalments for non-repayable support and loan support under the RRF of EUR 3.2 billion, net of pre-financing – of which, EUR 2.6 billion in grants and EUR 0.6 billion in loans.

Financial market perceptions of Portugal's sovereign debt are favourable. By the cut-off date of this report, the 10-year Portuguese government bonds yields stood at 3.6%, an increase of approximately 3 percentage points since December 2021 ([10]). Spreads against the German bund continued to narrow, reaching 0.8% and trading consistently below Portugal's main euro area peers. Since end-April 2023, the four major rating agencies upgraded Portugal's sovereign debt rating. Moody's and Standard and Poor's upgraded Portugal's outlook from 'stable' to 'positive', confirming their respective ratings of 'Baa2' and 'BBB+'. DBRS revised upwards its ratings from 'A (low)' to 'A', as well as Fitch from 'BBB+' to 'A-', both agencies confirming an 'stable' outlook.

Portugal's public debt-to-GDP ratio is forecast to remain on a downward path. The Portuguese public debt-to-GDP ratio is expected to further decrease in 2023, reaching 103.4%, compared with 112.4% recorded in 2022. In 2024 and 2025, the ratio is projected to further decline to 100.3% and 97.2%, respectively (see Section 3). The implicit interest rate on Portugal's public debt is expected to increase in 2023, on the back of a tightening of financing conditions, reaching 2.0% in 2023, 0.2 percentage point higher than in 2022. According to the Commission's debt sustainability analysis (see Annex 2), medium-term risks to Portugal's fiscal sustainability are high overall, and low in both the short- and long-term. Public debt-to-GDP developments remain vulnerable to a worsening of economic and financing conditions.

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



Source: European Commission.

Portugal retains the capacity to service its debt. The country's capacity to repay is supported in the short term by its comfortable cash buffer, the maturity structure of its debt, most of which with fixed rates, stable and diversified financing sources, and its debt currency denomination. The outstanding debt to the European Financial Stability Facility (EFSF) and European Financial Stability Mechanism (EFSM) is of EUR 25.3 billion and EUR 23.8 billion, respectively. An EFSM maturity of EUR 1.5 billion is scheduled at the end of 2023, with the next one of EUR 2.2 billion in 2026. The next EFSF loan repayment of EUR 1.5 billion is scheduled for 2025 (see Graph 5.1). Financial assistance loans were fully repaid to the IMF in December 2018.

Recovery and Resilience Facility Regulation (Regulation (EU) 2021/241).

([10]) In December 2021, the ECB started a path of monetary policy normalisation. Since then, it has raised its main policy rates by 4.5 percentage points, ended its net purchases under the pandemic emergency purchase programme (PEPP) and started unwinding the portfolio acquired under the asset purchase programme (APP).

ANNEX 1

Main macroeconomic and financial indicators

Table A1.1: **Selected economic indicators**

	2019	2020	2021	2022	2023	2024	2025
Real economy			*(percent change)*				
Real GDP	2.7	-8.3	5.7	6.8	2.2	1.3	1.8
Domestic demand incl. inventories	3.1	-5.4	5.9	4.4	0.9	1.8	2.1
Private consumption expenditure	3.3	-7.0	4.7	5.6	0.9	1.1	1.7
Government consumption expenditure	2.1	0.3	4.5	1.4	1.9	2.3	1.7
Gross fixed capital formation	5.4	-2.2	8.1	3.0	0.9	3.6	3.8
Exports of goods and services	4.1	-18.6	12.3	17.4	5.3	1.7	2.1
Imports of goods and services	4.9	-11.8	12.2	11.1	2.5	2.8	2.8
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	3.4	-4.9	5.4	4.4	1.1	1.8	2.1
Foreign trade	-0.4	-3.0	-0.2	2.3	1.3	-0.5	-0.3
Changes in inventories	-0.3	-0.5	0.6	0.1	-0.1	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.7	2.0	1.9	5.0	6.8	2.9	2.3
HICP	0.3	-0.1	0.9	8.1	5.5	3.2	2.4
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	6.7	7.0	6.6	6.0	6.5	6.5	6.4
Employment	0.8	-1.8	2.0	1.5	1.0	0.6	0.6
Compensation per employee	4.8	1.5	5.1	5.7	7.0	3.7	3.2
Labour productivity	1.9	-6.6	3.7	5.2	1.2	0.7	1.2
Unit labour costs	2.8	8.7	1.3	0.5	5.7	2.9	2.0
Public finance			*(percent of GDP)*				
General government balance	0.1	-5.8	-2.9	-0.3	0.8	0.1	0.0
Total revenue	42.6	43.4	44.6	43.8	43.3	44.6	44.4
Total expenditure	42.5	49.2	47.5	44.1	42.5	44.4	44.4
General government primary balance	3.1	-2.9	-0.5	1.6	2.8	2.4	2.3
Gross debt	116.6	134.9	124.5	112.4	103.4	100.3	97.2
Balance of payments			*(percent of GDP)*				
Current external balance	0.1	-1.2	-1.0	-1.3	1.6	1.1	0.8
Ext. bal. of goods and services	0.5	-2.1	-2.8	-2.4	1.1	0.7	0.5
Exports goods and services	43.5	37.0	41.4	49.6	48.5	48.2	48.1
Imports goods and services	43.1	39.2	44.2	52.0	47.4	47.4	47.6
			(EUR bn)				
Nominal GDP	214.4	200.5	216.1	242.3	264.5	275.8	287.0

Source: European Commission.

ANNEX 2
Debt sustainability analysis

This annex assesses fiscal sustainability risks for Portugal over the short, medium and long term. It follows the same multi-dimensional approach of the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission 2023 autumn forecast and including a technical change to anchor the fiscal variables to the structural primary balance of the first forecast year (t+1) as opposed to the second forecast year (t+2) in previous publications. This change aims to ensure a higher degree of stability and consistency with the ongoing work on the revision of the economic governance framework. This means that the debt and budget balance projections for t+2 (in this case 2025) can differ from the Commission 2023 autumn forecast. A more detailed description and explanation of this update will be published in the forthcoming Debt Sustainability Monitor 2023.

SHORT TERM RISKS

Short-term risks to fiscal sustainability are low. The Commission's early-detection indicator (S0) does not point to any major short-term fiscal risks (Table A2.2) ([11]). Government gross financing needs are expected to decrease to less than 8% of GDP on average over 2023-2024 (Table A2.1, Table 1). Financial markets' perceptions of sovereign risk are investment grade, as confirmed by main rating agencies.

MEDIUM TERM RISKS

Medium-term fiscal sustainability risks appear high.

The DSA baseline shows that the government debt ratio is expected to decline but remain at a high level in the medium term (at around 83% of GDP in 2034) (Graph A2.1,Table A2.1) ([12]). The debt reduction is supported by the assumed structural primary surplus of 2.1% of GDP. This appears ambitious compared with past performance, suggesting limited fiscal room of maneouvre ([13]). The debt decline also benefits from a still favourable but declining snowball effect of around 0.7% of GDP annualy on average over 2025-2034, which is supported by the impact of Next Generation EU (NGEU). Finally, government gross financing needs are expected to slightly increase by the end of the projection period, above the average over 2023-2024.

The baseline projections are stress-tested against four alternative deterministic scenarios to assess the impact of changes in key assumptions (Graph A2.1). For Portugal, all the stress tests scenarios would lead to worse results as compared to the baseline, with particularly adverse developments under the *historical structural primary balance (SPB) scenario* (i.e. the SPB returns to its historical 15-year average of 0.4% of GDP). Under this tress scenario, the debt ratio would be higher than under the baseline by about 13 pps. of GDP in 2034. Under the *adverse interest-growth rate differential scenario* (i.e. the *interest-growth rate* deteriorates by 1 pp. compared with the baseline), the debt ratio would be higher than under the baseline by around 7 pps. of GDP in 2034. Under the *financial stress scenario* (i.e. interest rates temporarily increase by 1.8 pps. compared with the baseline) debt ratio would be higher by only around 1 pp. in 2034. A similar impact on the debt ratio (about 1 pp) is projected for 2034 under the *lower structural primary balance scenario* (i.e. the projected cumulative improvement in the SPB over 2023-2024 is halved).

([11]) The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of fiscal and financial-competitiveness indicators that have proven to be a good predictor of emerging fiscal stress in the past.

([12]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline include in particular: (i) a structural primary surplus, before ageing costs, of 2.1% of GDP from 2024 onwards; (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 ahead); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10; (iv) real GDP growth rates from the Commission 2023 autumn forecast until 2025, followed by the EPC/OGWG 'T+10 methodology projections between T+3 and T+10 (average of 0.8%); (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, November 2020). For information on the methodology, see the 2022 Debt Sustainability Monitor.

([13]) This assessment is based on the consolidation space indicator, which measures the frequency with which a tighter fiscal position than assumed in a given scenario has been observed in the past. Technically, this consists of looking at the percentile rank of the projected SPB within the distribution of SPBs observed in the country, taking into account all available data from 1980 to 2022.

Table A2.1: **Baseline debt projections**

	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Gross debt ratio (% of GDP)	**124.5**	**112.4**	**103.4**	**100.3**	**97.2**	**94.1**	**91.5**	**89.4**	**87.6**	**86.1**	**84.9**	**84.0**	**83.4**	**82.9**
Changes in the ratio	-10.3	-12.1	-9.0	-3.1	-3.1	-3.2	-2.6	-2.1	-1.8	-1.5	-1.2	-0.9	-0.6	-0.5
of which														
Primary deficit	0.5	-1.6	-2.8	-2.4	-2.2	-1.9	-1.7	-1.3	-1.1	-0.9	-0.7	-0.5	-0.4	-0.2
Snowball effect	-7.3	-11.6	-7.4	-2.0	-1.7	-1.2	-0.9	-0.7	-0.7	-0.6	-0.5	-0.4	-0.3	-0.3
Stock-flow adjustments	-3.5	1.1	1.2	1.3	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs (% of GDP)	12.1	10.7	7.6	7.5	7.7	7.5	7.6	7.7	7.6	7.3	9.5	9.4	9.1	8.3

Source: European Commission services.

The stochastic projections indicate medium risks, pointing to moderate sensitivity of these projections to plausible unforeseen events ([14]). These stochastic simulations indicate a 26% probability that the debt ratio will be higher in 2028 than in 2023, implying medium risks given the high debt level. In addition, the uncertainty surrounding the baseline debt projections is high: the difference between the 10th and 90th debt distribution percentiles points to an 80% probability that the debt ratio will be within a large range of 52 pps. in five years' time (Graph A2.2).

LONG TERM RISKS

Long-term fiscal sustainability risks appear overall low. This assessment is based on the combination of two fiscal gap indicators, capturing the required fiscal effort to stabilise debt (S2 indicator) and bring to 60% of GDP (S1 indicator) over the long-term ([15]).

The S2 indicator points to low fiscal sustainability risks. The indicator shows that, relative to the baseline, the SPB would not need to improve to ensure debt stabilisation over the long term. This result is underpinned by a favourable initial budgetary position (-1.7 pps. of GDP) and the projected decline in ageing-related costs (contribution of -1 pp. of GDP). Ageing costs' developments are primarily driven by a projected decrease in public pension expenditure (-2.9 pps. of GDP), which is only partly offset by a projected increase in health-care and long-term care spending (+1.7 pps. of GDP) (Table A2.1, Table A2.2).

The S1 indicator points to low fiscal sustainability risks. The indicator shows that Portugal does not need to further improve its fiscal position to reduce its debt to 60% of GDP by 2070. This result is mainly driven by the current favourable initial budgetary position (contribution of -2.2 pps. of GDP), which is partially offset by the high Portuguese government debt ratio (contribution of 0.8 pp. of GDP), and the projected ageing-related public spending (contribution of 0.8 pp. of GDP) (Table A2.1, Table A2.2). ([16])

Finally, several additional risk factors need to be considered in the assessment. On one hand, risk-increasing factors are related to contingent liability risks linked to State guaranteed credit lines, other country-specific factors as the ongoing requests for a financial rebalancing of PPPs and vulnerabilities in some public corporations, and Portugal's negative net international investment position. On the other-hand, risk-mitigating factors include Portugal's comfortable cash buffer, the maturity structure of its debt , most of which with fixed rates, relatively stable financing sources (with a diversified and large investor base) and the currency denomination of debt. Portugal's debt management strategy targeting the smoothening of the debt redemption profile also contributes to mitigate risks.

([14]) The stochastic projections show the joint impact on debt of 2000 different shocks affecting the government's budgetary position, economic growth, interest rates and exchange rates. This covers 80% of all the simulated debt paths and therefore excludes tail events.

([15]) The S2 fiscal sustainability indicator measures the permanent SPB adjustment in 2024 that would be required to stabilise public debt in the long term. It is complemented by the S1 indicator, which measures the permanent SPB adjustment in 2024 to bring the debt ratio to 60% by 2070. For both the S1 and S2 indicators, the risk assessment depends on the amount of fiscal consolidation needed: 'high risk' if the required effort exceeds 6 % of GDP, 'medium risk' if it is between 2% and 6% of GDP, and 'low risk' if the effort is negative or below 2% of GDP. The overall long-term risk classification combines the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 if it signals a higher risk than S2. See the 2022 Debt Sustainability Monitor for further details.

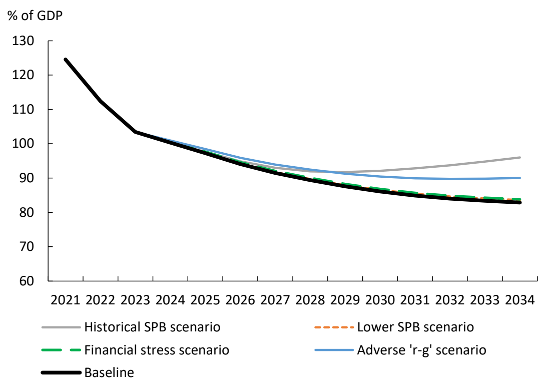
([16]) The impact of age-related public spending differs between S1 and S2 because S1 considers the period up to 2070 while S2 considers an infinite horizon.

Table A2.2: **Breakdown of the S1 and S2 sustainability gap indicators**

		S1	S2
Overall index (pps. of GDP)		**-0.5**	**-2.7**
of which			
Initial budgetary position		-2.2	-1.7
Debt requirement		0.8	
Ageing costs		0.8	-1.0
of which	*Pensions*	-0.6	-2.9
	Health care	1.0	1.3
	Long-term care	0.3	0.4
	Others	0.1	0.2

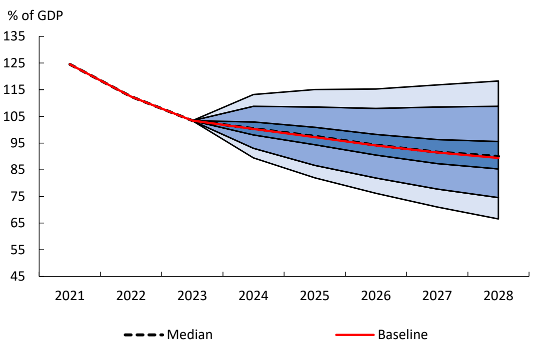
Source: European Commission services.

Graph A2.1:**Deterministic debt projections**



Source: European Commission services.

Graph A2.2:**Stochastic debt projections 2024-2028**



Source: European Commission services.

Table A2.3: **Heatmap of the fiscal sustainability risks for Portugal**

Short term	Medium term - Debt sustainability analysis (DSA)								Long term		
Overall (S0)	Overall		Deterministic scenarios: Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress	Stochastic projections	S2	S1	Overall (S1 + S2)
LOW	HIGH	Overall	MEDIUM	HIGH	MEDIUM	HIGH	MEDIUM	MEDIUM	LOW	LOW	LOW
		Debt level (2034), % GDP	82.9	96.0	83.6	90.0	83.8				
		Debt peak year	2023	2023	2023	2023	2023				
		Fiscal consolidation space	22%	42%	22%	22%	22%				
		Probability of debt ratio exceeding in 2028 its 2023 level						26%			
		Difference between 90th and 10th percentiles (pps. GDP)						51.8			

(1) Debt level in 2034. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%.
(2) The debt peak year indicates whether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak.
(3) Fiscal consolidtation space measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low.
(4) Probability of debt ratio exceeding in 2028 its 2023 level. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level).
(5) the difference between the 90th and 10th percentiles measures uncertainty, based on the debt distribution under 2000 different shocks. Green, yellow and red cells indicate increasing uncertainty.

Source: European Commission services.

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