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Post-Programme Surveillance Report

Portugal, Spring 2022

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Institutional Paper 176

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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 29 April 2022. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2022 spring forecast released on 16 May 2022 (with cut-off date 29 April 2022).

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([1]) The executive summary of this report was adopted as Commission Communication C(2022)3502 on 18 May 2022. The rest of the report reflects the findings of the Staff Working Document (SWD(2022)702) 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
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
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 fifteenth post-programme surveillance (PPS) mission of Commission staff to Portugal, in liaison with ECB staff*. The mission took place in the form of online video meetings from 21 to 28 March 2022.*

Since the conclusion of the previous PPS mission in September 2021, Portugal's economy has continued to recover from the pandemic-inflicted contraction in 2020*. GDP increased by 4.9% in 2021, broadly in line with expectations, and recovered slightly more than half of the level lost in 2020. Growth is expected to continue at a sound pace in 2022 though the outlook on global demand has weakened somewhat as commodity markets and global supply chains have been adversely affected by Russia's invasion of Ukraine beginning in late February 2022. In the light of Portugal's low exposure to the war region, the direct impact on GDP and employment is expected to be relatively limited. However, like in other EU Member States, the impact on inflation is projected to be significant, reflecting the increase in commodity prices, particularly energy, but also metals, food and construction materials. Price developments are also set to weigh negatively on the external balance in 2022, despite the expected strong recovery in the tourism sector. Overall, the economic outlook remains favourable but the balance of risks has moved further to the downside.*

Public finances are benefiting from the gradual economic recovery*. In 2021, the observed increase in public revenue, in particular in cycle-dependent tax revenue and the inflow of EU funds, more than offset the continued expansion of public spending, bringing the public deficit to 2.8% of GDP, after 5.8% in 2020. The public deficit turned out significantly below government plans in 2021, which supports the expectation of a comparatively favourable outlook for public finances in 2022. The fiscal position is projected to continue to improve in 2022 and thereafter, amid a wind-down of crisis mitigation measures and a sustained economic rebound. At the same time, pre-pandemic upward pressures on current public spending are set to remain in place, notably stemming from ageing-related spending and the public sector wage bill, while measures are being taken to mitigate the impact of high energy prices. Potential challenges emerge from public contingent liabilities. Strong momentum for fiscal-structural reforms remains important to improve the quality and composition of public finances, in particular those aimed at enhancing expenditure control and cost-efficiency, strengthening the sustainability and resilience of the National Health Service, and tackling long-lasting challenges in state-owned enterprises. Reforms in these areas are embedded in Portugal's recovery and resilience plan, and their implementation is ongoing.*

The overall picture in the financial sector is rather positive though challenges remain*. Banks posted overall good financial results for 2021 as profitability improved and solvency ratios remained stable. The end of most credit moratoria in September 2021 did not trigger a major wave of bad loans as borrowers benefited from the economic recovery. Moreover, non-performing loans (NPL) kept decreasing while banks retained a prudent approach to loan impairments. Going forward, the key risk stems from the uncertainty brought by Russia's invasion of Ukraine. While banks' direct exposure to Russia and Ukraine is very low, the many possible second-round effects, including via the rise in global uncertainty, could eventually weigh on banks' balance sheets and profits.*

Risks to government financing conditions and the capacity to repay remain low*. On the back of the improving economic conditions and a debt-reducing stock-flow adjustment, the public debt-to-GDP ratio resumed a downward path in 2021, declining to 127.4%, down from its historical peak of 135.2% a year earlier. The public debt-to-GDP ratio is expected to maintain a steadily declining trajectory in 2022 and thereafter, narrowing to below its pre-pandemic level in 2023. Although government financing needs increased further in 2021, on top of the 2020 surge driven by the COVID-19 pandemic, they are expected to ease as of 2022, supported by relatively favourable financing conditions and comfortable cash buffers. Sustained efforts to smoothen the public debt redemption profile, extend the debt maturity, and contain interest expenditure, have mitigated fiscal sustainability challenges. 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, as well as the associated growth-enhancing spending, also contribute to improving the government 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 fifteenth post-programme surveillance (PPS) mission to Portugal between 21 and 28 March 2022. 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])

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.

This report reflects information available and policy developments that have taken place until 29 April 2022. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2022 autumn forecast released on 16 May 2022 (with cut-off date 29 April 2022).

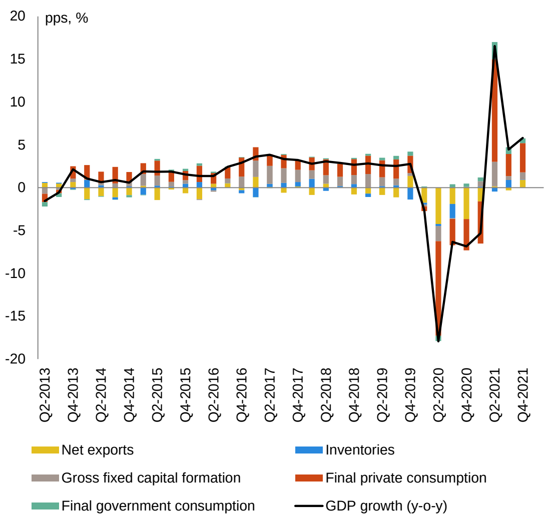
([3]) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Portugal's GDP increased by 4.9% in 2021 following a pandemic-driven drop by 8.4% in 2020. Investment and exports of goods rebounded to above pre-pandemic levels in 2021 while private consumption recovered at a somewhat slower pace as some services continued to face restrictions for most of the year. Across supply components, construction rose 6.9% above its pre-pandemic level while the industrial and service sectors were unable to fully recover. Tourism picked up substantially in 2021 but remained well below its pre-pandemic level as many restrictions in international travels were still in place. In quarterly terms, growth peaked in the second quarter of 2021 and moderated afterwards as pent-up demand gradually waned and services faced a new round of restrictions towards the end of the year.

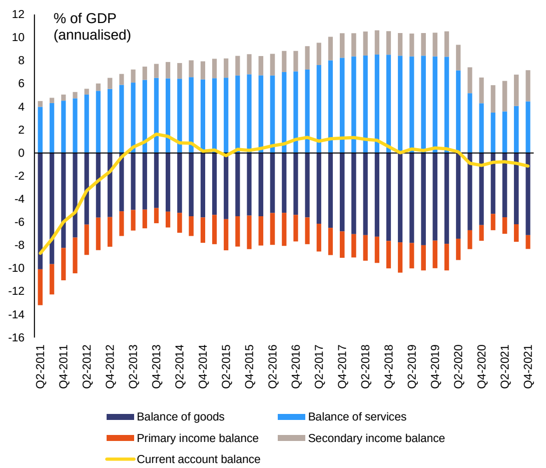
Graph 2.1: **Real GDP growth and components**



Source: INE

Growth is expected to remain strong in 2022. Growth picked up again in the first quarter of 2022 as most containment measures were lifted in mid-January, while disruptions in global supply chains as a result of Russia's invasion of Ukraine starting in late February were offset by the rebound in private consumption and tourism. As of the first quarter of 2022, GDP already exceeded its pre-pandemic level. In full-year terms, the service sector and particularly tourism are projected to support substantially Portugal's economic growth. Although Portugal has a very low exposure to Russia and Ukraine, the impact of the war on commodity prices, global supply chains and business sentiment is expected to partly offset the growth momentum in Portugal, particularly in the industrial sector. According to the Commission 2022 spring forecast, GDP is set to increase by 5.8% in 2022 and 2.7% in 2023. Risks to the growth outlook have moved to the downside as a result of Russia's invasion of Ukraine and related uncertainty in global demand and security of supplies.

Graph 2.2: **Current account balance**



Source: Banco de Portugal

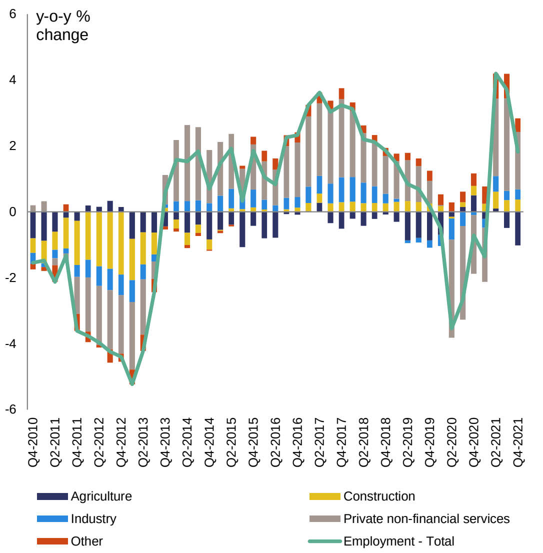
The current account deficit remained stable at 1.1% of GDP in 2020 and 2021, according to balance of payments data. Despite some improvement in the service balance, net travel receipts were well below pre-pandemic levels in 2021. At the same time, the balance of trade in goods worsened in 2021 amid higher demand for imports of investment goods and increased prices of energy imports. In 2022, foreign tourism is projected to recover substantially, moving close to its pre-pandemic level. The service balance is set to improve accordingly. However, a significant worsening in the terms of trade, due mainly to high prices of energy imports, is expected to worsen further the goods balance. Overall, the current account deficit is projected to widen in 2022 before improving again in 2023 assuming a downward correction in energy prices pushes the terms of trade into positive territory.

The net international investment position (NIIP) improved substantially in 2021. Favourable valuation effects as well as increased inflows in the capital account, including the EUR 2.2 billion pre-financing under the Recovery and Resilience Facility, improved Portugal's NIIP from -209.7 billion at the end of 2020 to -202.6 billion at the end of 2021. The NIIP share in GDP moved from -105% to -96% for the same period, moving above the pre-pandemic ratio of -100%. In light of the expected temporary deterioration in the current account in 2022, the NIIP is set to remain broadly stable in absolute terms during the year but to retain its favourable path in relative terms along with the projected substantial increase in nominal GDP.

The labour market outperformed expectations. The unemployment rate dropped from 7.0% in 2020 to 6.6% in 2021. On a monthly basis, the unemployment rate reached 5.8% in December 2021 and remained at that level in January and February 2022. All headline labour market indicators, with the exception of hours worked and youth unemployment, not only recovered to pre-pandemic levels in 2021 but reached their best historical values towards the end of 2021 and in early 2022. The breakdown of employment dynamics across sectors in 2020-2021 shows that new hires in retail trade, professional and scientific activities, as well as education and health services more than offset job losses in tourism. The record high employment rate ([4]) of 63.7% reached in January 2022 suggests that some sectors, e.g. construction, could face labour supply constraints. The job vacancy rate for the whole labour market remained very low at around 1% in the last quarter of 2021 against an EU average of 2.6%.

Pandemic related measures continued to support the labour market. Government support schemes played an essential role in the resilience of the labour market during the pandemic. While some of the support measures expired by the end of September 2021, the government decided to extend the duration of two support schemes – for progressive resumption of activity and simplified furloughs. The decision contributed to a more gradual withdrawal of labour support than previously expected. As payments under the remaining schemes declined substantially in early 2022 and the uncertainty in the global business environment remains high, the pace of the improvement on the labour market is likely to moderate. Nevertheless, the labour market is projected to remain on a positive trajectory given the favourable outlook for the tourism sector.

Graph 2.3: **Employment evolution by sectors**



Source: Eurostat

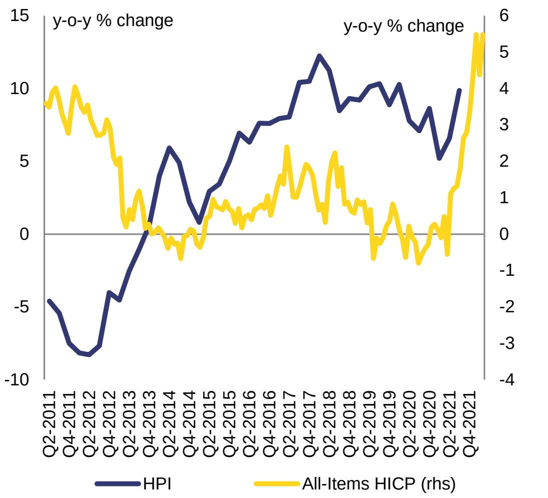
Inflation increased from -0.1% in 2020 to 0.9% in 2021 due mainly to surging energy prices. In quarterly terms, HICP inflation reached 2.4% (y-o-y) in the last quarter of 2021 and rose further to 4.4% (y-o-y) in the first quarter of 2022 as energy prices and prices of other commodities, including metals, construction materials and agricultural products, kept growing. Those supply factors also had a visible pass-through effect on core inflation, which rose from 1.6% (y-o-y) in the last quarter of 2021 to 3.3% in the first quarter of 2022. The increase in energy prices reached nearly 16% (y-o-y) in the first quarter of 2022, due mainly to crude oil, while regulatory changes on the retail electricity and natural gas market shielded households from the steep increase in wholesale prices. Based on the futures markets for energy and other commodities, inflation is projected to moderate somewhat in the second half of 2022 and more significantly in 2023.

House prices continued growing at a faster pace than consumer prices. Following an increase by

([4]) Based on data of the national statistical office (INE) for the age group of 16 to 74 years

8.8% in 2020, house price growth picked up to 9.4% in 2021. The deflated house price index, adjusted by the private consumption deflator, increased by 8.0% and 8.1% respectively. Similar to developments in previous years, demand for real estates was mainly driven by non-debt financing, including foreign investments and the accumulation of household savings in the context of low interest rates on bank deposits.

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

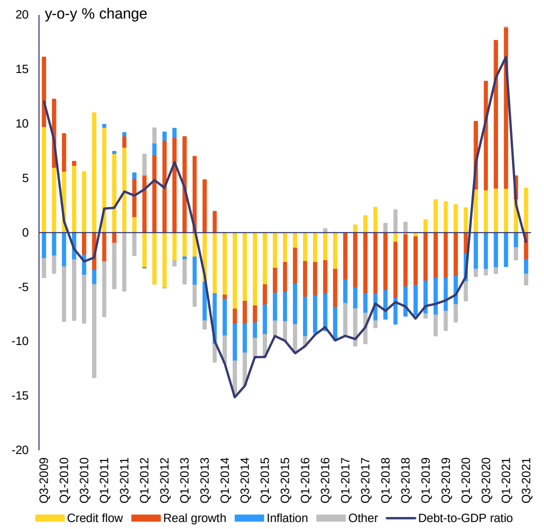


Source: Eurostat

2.2. PRIVATE DEBT

Private indebtedness dropped in 2021 after a one-off spike in 2020. Although the stock of private debt increased in absolute terms in 2021, its ratio to GDP returned to a downward trend after a temporary increase in 2020 driven by the outbreak of the COVID-19 pandemic. Helped by the strong rebound in GDP, the ratio of private debt to GDP is estimated at around 160% at the end of 2021 relative to 164% of GDP at the end of 2020. The ratio however remained above its pre-pandemic low of 149% reached at the end of 2019. Both households and corporates contributed to the decrease in the private debt ratio in 2021. The debt structure continued to improve as the NPL ratio decreased further, which is discussed in greater detail in Chapter 4 of this report. In net terms, the liquidity position of households and corporates improved, reflecting the steady growth in deposits.

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



Source: Eurostat, ECB, Banco de Portugal

The outlook for private indebtedness remains favourable. The projected economic growth along with the recent inflation spike is set to support a further decrease in private indebtedness in 2022-2023 in the form of passive deleveraging. Given the latest estimates on the evolution of the absolute value of private debt and GDP, the underlying debt ratio is set to reach the pre-pandemic ratio towards the end of 2022 or in 2023 at the latest. In parallel, the debt repayment capacity in the corporate sector is benefiting from increased funding available at the state-owned promotional bank Banco Português de Fomento (BPF) to address the undercapitalisation of the corporate sector, particularly for vulnerable but viable firms affected by the pandemic. This reflects the setup of a EUR 1.3 billion capitalisation fund in late 2021, which is managed by BPF and is part of the Portuguese recovery and resilience plan (RRP).

3. PUBLIC FINANCES

3.1. Fiscal performance and outlook

Public revenue benefited from the start of the economic recovery in 2021. Total public revenue increased by 10% y-o-y in 2021 (4.4 pps. of the nominal GDP level in 2020). The largest contribution to this increase resulted from the expansion of tax and social contribution revenue by 6.8% y-o-y (2.5 pps. of GDP), propelled by the observed economic rebound. Particularly noteworthy were the increases by 10.6% y-o-y in the revenue from taxes on production and imports (1.5 pps. of GDP), mainly reflecting an acceleration of private consumption in Q4-2021, and by 6% y-o-y (0.8 pps. of GDP) in the revenue from social contributions, echoing the continued resilience of the Portuguese labour market to the COVID-19 pandemic and the corresponding increase observed in the public and private wage bill. Public revenue also benefited from the additional inflow of EU funds in 2021 (above 1 pp. of GDP), including within the scope of REACT-EU, and the one-off reimbursement of the pre-paid margin on the financial assistance loan by the European Financial Stability Facility (about 0.5 pps. of GDP).

While the effects of the COVID-19 crisis on public spending remained apparent in 2021, they were magnified by pre-pandemic trends. Total public expenditure increased by 3% y-o-y in 2021 (1.5 pps. of the nominal GDP level in 2020), driven by the expansion of current spending by 4.1% y-o-y (1.9 pps. of GDP). The observed increment in current spending in 2021 reflected upward pressures that were already at play before the COVID-19 outbreak. In particular, expenditure on social benefits increased by 2.8% y-o-y (0.6 pps. of GDP), notably pension spending driven by Portugal's demographic ageing, compounded by recurrent pension increases above the reference rate for pension indexation (linked to inflation and real GDP growth). Furthermore, compensation of employees expanded by 4% y-o-y (0.5 pps. of GDP), as the number of public sector employees reached its peak of the last decade in Q4-2021 and public wages maintained the gradually accelerating trend observed in recent years. In addition, and despite the historically high level observed in 2020, spending on subsidies recorded a further increase by 15.2% y-o-y in 2021 (0.3 pps. of GDP), reflecting the cost of crisis mitigation measures, primarily comprising subsidies to firms in relation to short-time work schemes and similar measures. At the same time, capital expenditure receded by 8.4% y-o-y in 2021 (-0.4 pps. of GDP), as a result of the lower cost of previously contracted bank rescue operations, as well as of rescue aid for the air transport sector (both declining by 0.3 pps. of GDP), compared with 2020. Importantly, there was revived momentum in public investment in 2021, which increased by 19% y-o-y (0.4 pps. of GDP), in line with the customary multiannual profile of EU-financed investments, which tend to accelerate at the end of each programming period.

The surprise on the revenue side more than offset the still-increasing spending, leaving the public deficit below government plans in 2021. The State Budget for 2021 had set a public deficit target of 4.3% of GDP, after the 5.8% of GDP recorded in 2020. However, the fact that public revenue growth was more buoyant than planned, especially in cycle-dependent tax and social contribution revenue, combined with somewhat less dynamic public expenditure across the board, led to a considerably lower public deficit of 2.8% of GDP in 2021. Crucially, the lower-than-planned public deficit in 2021 offers a more favourable starting position for public finances in 2022.

After the peak driven by the COVID-19 crisis in 2020, Portugal's public debt-to-GDP ratio started to decrease again in 2021. The public debt-to-GDP ratio had been on a steady downward path since 2016, but the crisis-related primary public deficit, an unfavourable snowball effect (translating the differential between the average interest rate and nominal GDP growth), and the positive stock-flow adjustment (reflecting the difference between the change in debt and the deficit) brought it to an all-time high of 135.2% in 2020. However, this dynamic was temporary, since the public debt-to-GDP resumed its pre-pandemic downward path in 2021, when it declined by 7.8% of GDP, to 127.4%. Contributing to this decrease were a debt-reducing snowball effect (4.7% of GDP), with the favourable denominator effect arising from strong nominal GDP growth (7.2% of GDP) more than offsetting the still non-negligible interest burden (2.4% of GDP). This was complemented by a debt-reducing stock-flow adjustment (3.4% of GDP), on the back of a reduction of the cash buffer in 2021, and the pre-financing of 13% (1% of GDP) of the total grants and loans associated with future spending over the lifetime of Portugal's recovery and resilience plan (RRP) (see Section 5) ([5]). These positive developments, however, coincided with another, albeit smaller, primary public deficit in 2021 (0.4% of GDP).

Portugal's fiscal position is expected to continue to improve in 2022, amid a wind-down of crisis mitigation measures and an economic rebound. According to Portugal's 2022 Draft Budgetary Plan, as submitted to the Commission and the Eurogroup on 14 April 2022, the public deficit is set to narrow further to 1.9% of GDP in 2022. The enhanced fiscal outlook for 2021 results from the economic recovery gaining momentum, supported by the implementation of Portugal's RRP, and the gradual phasing-out of crisis mitigation measures. In this context, the public debt-to-GDP ratio is planned to decline further to 120.7% in 2022. For 2023, according to Portugal's 2022 Stability Programme, as submitted to the Commission and the Council on 29 April 2022, both the public deficit and debt are planned to remain on steadily decreasing paths, reaching 0.7% and 115.4% of GDP, respectively. Against that background, the public debt-to-GDP ratio is seen as decreasing to below its pre-pandemic level in 2023. These plans for 2022 and 2023 are broadly in line with the Commission 2022 spring forecast for those years. Looking ahead, the 2022 Stability Programme – which covers the period 2022-2026 – projects a broadly balanced budget as of 2025, and a public debt-to-GDP ratio close to 100% at the end of the programming period. At the same time, possible challenges to the fiscal outlook relate, among others, to the considerable size of public contingent liabilities, linked to crisis-related publicly guaranteed credit lines and to persisting vulnerabilities in some public corporations.

3.2. Policy issues

Improving the quality and composition of Portugal's public finance remains critical. On 18 June 2021, the Council adopted a recommendation delivering an opinion on the 2021 Stability Programme of Portugal. ([6]) 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. In addition, 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 would help provide the necessary financing for public policy priorities – namely, for investment to boost potential growth and support the green and digital transitions –, thereby contributing to the long-term sustainability and resilience of public finances.

Portugal is implementing both cross-cutting and sector-specific measures to mitigate the impact of high energy prices. Cross-cutting measures notably include a temporary subsidy on fuel consumption, a reduction in fuel tax, a reimbursement of the additional VAT raised on the higher fuel prices via fuel tax (which is calibrated on a weekly basis to neutralise the tax burden on fuel consumption), and a freeze on the carbon rate under the fuel tax. In turn, sector-specific measures include a temporary subsidy for the public road passenger transport sector (this is, buses and taxis), extended benefits under the vehicle and fuel taxes for the road haulage sector, as well as a tax deduction under corporate income tax for the transport sector as a whole. Portugal also allocated EUR 150 million of carbon tax revenues to subsidise the national electricity system, with a view to lowering access tariffs to the electricity grid. In addition, a one-time social benefit of EUR 60 was granted in April 2022 to low-income households most vulnerable to the rising food prices. The combined budgetary impact of all these measures is estimated at around 0.6% of GDP by end-June 2022, when all such measures are currently planned to expire. In addition, Portugal's

([5]) Portugal's RRP consists of investments and reforms to promote a strong recovery, strengthen economic and social resilience, and foster the green and digital transitions. For details, see 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.

([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.

2022 Draft Budgetary Plan also provides for additional spending related to the costs of dealing with the humanitarian crisis following the Russia's invasion of Ukraine, in particular to support displaced persons from Ukraine (EUR 50 million).

A strong budgetary framework is key for sound fiscal policy-making. The full and effective implementation of the 2015 Budgetary Framework Law (BFL) – which has experienced systematic delays since its adoption – has a clear potential to strengthen overall budgetary planning and monitoring, through a stronger medium-term focus and enhanced transparency. Moreover, this would go hand-in-hand with adherence to a new accrual-based public accounting system by all government sectors and bodies. A number of measures in these fields are being gradually implemented. In addition, 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 important to facilitate the rechannelling of public resources to new strategic priorities, such as delivering on the green and digital transitions. A number of measures towards these goals have been enshrined in Portugal's RRP, combined with wide-ranging upgrades of the information systems for public financial management, which are expected to facilitate their operationalisation.

The financial situation of the National Health Service (NHS) worsened in 2021, due to the continued incidence of COVID-19. Before the outbreak of the COVID-19 pandemic, accelerating spending on wages, medicines, and medical services, aggravated by inner weaknesses in budgetary planning and cost-efficiency, were already posing critical challenges to the NHS, as evidenced by the persistently high arrears in hospitals. The continued impact of the COVID-19 pandemic in 2021 – with the related additional hiring of health professional mostly becoming of a permanent nature –, combined with a gradual catching-up in non-pandemic activity in the course of the year, weighed significantly on the NHS balance, which deteriorated to a deficit of 0.5% of GDP. Consequently, additional transfers from the State budget were needed in 2021, adding to the historically high transfers carried out in 2020. In addition, the track record of an in-year accumulation of arrears, combined with 'ad-hoc' clearance measures at year-end, was repeated in 2021, with possible spill-over effects on supply-chain relationships. Such clearance measures were particularly sizeable in 2021, at 0.5% of GDP.

Reforms to strengthen the NHS's efficiency and financial sustainability are being implemented gradually. The comprehensive plan designed in 2019, and targeting 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, is planned to be take effect gradually in the context of the deployment of Portugal's RRP. As in past years, most of the hospitals' draft budget and activity plans ([7]) were not deemed eligible for approval by the Minister of Finance and the respective line Minister in 2021. At the same time, a new management contract template for state-owned enterprises (SOEs) operating in the NHS is planned to enter into force in 2022, with a view to strengthening managers' accountability and encouraging their overall performance. The establishment of Integrated Responsibility Centres is progressing at good pace, and the ongoing decentralisation process, whereby responsibilities in the field of health are to be transferred from the State to the municipalities, is planned to be completed by the end of this year.

The COVID-19 crisis exacerbated pre-existing challenges to the financial sustainability of SOEs. Their financial situation was severely impacted by the COVID-19 pandemic in 2020, with the net incomes of several SOEs remaining negative in 2021, especially in the health and transport sectors. After the sizeable rescue aid granted to TAP Air Portugal (the Portuguese flag carrier airline) and SATA Air Açores in 2020 (0.7% of GDP), additional, albeit moderating, deficit-increasing impacts were recorded in 2021 and are again expected for 2022 (at 0.4% of GDP in 2022 and 0.3% in 2023), according to Portugal's latest Draft Budgetary Plan. The debt-to-GDP ratio

([7]) Budget and activity plans are to be prepared on an annual basis, spelling out hospitals' main lines of strategic and operational action and, importantly, their staff and investment planning over a three-year horizon.

of non-financial SOEs had decreased to 18.5% by Q4-2019. On the back of the COVID-19 crisis, it rose to 20% in Q1-2021, before narrowing to below its pre-pandemic level in Q4-2021, when it reached 18.2% (of which 14.7 pps. related to SOEs inside the general government perimeter). As provided for in Portugal's RRP, policy action was taken to improve the financial sustainability of SOEs, through a new management contract template introducing a system of incentives to support managers' performance and good governance ([8]). The authorities are now working on additional implementing provisions to facilitate the operationalisation of the system of managerial incentives embedded in the new management contract template. Some additional efficiency savings are expected in 2022, thanks to the liquidation of a few SOEs. In the field of public-private partnerships (PPPs), possible challenges emerge from private contractors filing pandemic-related rebalancing requests to the State.

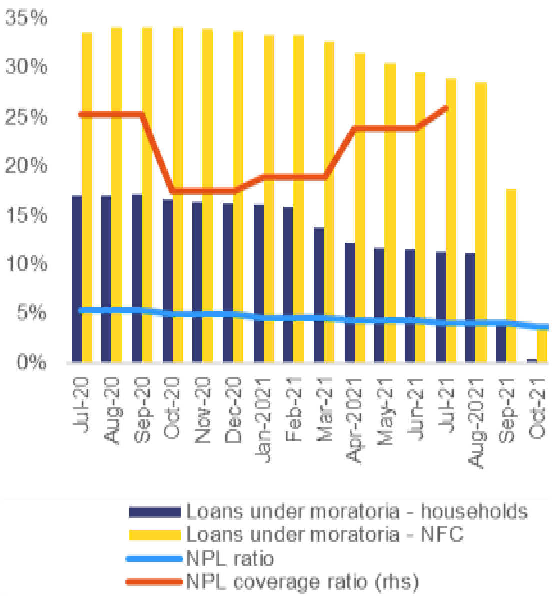
([8]) Government Order No 317-A/2021 of 23 December, establishing the rules regarding eligibility, composition, determination and attribution to public managers, who exercise executive functions in public companies of the State Corporate Sector, of a variable remuneration associated with the recognition and encouragement of sound management practices in state-owned enterprises.

4. FINANCIAL SECTOR

Banks' profitability rebounded to reach pre-pandemic levels, but challenges remain. The banking sector's profitability recovered in 2021 from the pandemic marked 2020. The aggregate return on assets (ROA) stood at 46 basis points (bps) against just 5bps and 45bps in 2020 and 2019, respectively (see Table 4.1). Total revenues increased, shifting away from shrinking net interest income towards more volatile income sources such as revenue from financial operations. The sector's performance also benefitted from improving efficiency (aggregate cost/income ratio of 53.4% in 2021 as compared to 58% in 2020) and a major decline in loan impairment charges dropping by almost two-thirds compared to 2020. Solvency remained stable throughout the past year (at 18% capital adequacy ratio), while the non-performing loans (NPL) ratio continued on its downward trend to reach 3.5% ([9]) at the end of 2021 (see Graph 4.1), a remarkable development, especially given the challenging environment. The domestic banking sector has a very limited direct exposure to Russia and Ukraine, limiting direct impacts from the current geopolitical situation. Nonetheless, second round effects, including higher energy prices and global supply chain constraints, could weigh on the profitability of the financial sector over 2022-2023.

Economic growth and public guarantees have driven the corporate debt stock higher, while households' mortgage transactions have also increased. Credit growth was positive in 2021 for both non-financial corporates (NFC) as well as households, but the dynamics substantially weakened in the second half of 2021 as guarantees and moratoria were being phased out. The stock of bank credit of the private NFC sector rose by 2.2% in 2021, driven by micro companies (7.7% average annual rate increase) and strong credit demand from the industrial sector (7.0% average annual rate increase). Public support measures kept playing an important role as, at end 2021, a non-negligible part of corporate loans was benefitting from some public sector guarantee. Households' financial resilience was also boosted through the public support measures, still in place for a part of 2021, as well as by the very positive labour market performance. The aggregate stocks of loans to households rose by 3.9% in 2021, driven both by consumer and mortgage lending, increasing by 2.4% and 4.4% respectively. The growth in the stock of household mortgages stabilised from Q3-2021 onwards, after having increased robustly during the first three quarters of 2021 (4.6% annualised as of September 2021, dropping to 3.3% in January 2022). The share of real estate transactions financed via domestic bank credit remained stable at around 50% since end-2016, well below the levels observed prior to the sovereign debt crisis (approximately 75% in 2009). The remaining part of these transactions was financed either directly from savings or related to non-residents purchases.

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



Source: Banco de Portugal

Portuguese banks continue paring down their still above-EU-average NPL ratio. The NPL ratio continued to decline to 3.9% in Q3-2021, from 4.5% in Q1-2021, but it is still higher than the 2.1% ([10]) EU average in Q3-2021. Data of Banco de Portugal show a further decrease in the country's NPL ratio to 3.5% at the end of 2021. Although the expiration of most of the moratoria at the end of September 2021 has not resulted in a noticeable increase of new NPLs for the time being, the share of stage 2 loans, which have

([9]) Source: Banco de Portugal

([10]) Source: ECB

Table 4.1: **Financial stability indicators**

	Portugal											Euro area	EU
in %	Q4-2016	Q4-2017	Q4-2018	Q4-2019	Q1-2020	Q2-2020	Q3-2020	Q4-2020	Q1-2021	Q2-2021	Q3-2021	Q3-2021	Q3-2021
Non-performing loans	17,2	13,3	9,4	6,1	5,9	5,5	5,3	4,9	4,6	4,3	4,0	2,1	2,1
o/w foreign entities	10,7	7,6	4,9	3,8	3,8	3,9	3,8	-	-	-	-	-	-
o/w NFC & HH sectors	17,5	14,6	10,5	6,9	6,8	6,6	6,2	-	-	-	-	-	-
o/w NFC sector	29,4	25,2	18,5	12,3	11,9	11,1	10,6	9,8	9,3	8,7	8,4	4,2	4,1
o/w HH sector	8,7	7,1	5,1	3,7	3,7	3,6	3,5	3,4	3,4	3,1	3,1	2,5	2,5
Coverage ratio	45,4	49,9	52,4	51,7	51,6	53,2	55,8	55,4	55,4	55,8	56,0	46,7	46,5
Return on equity(1)	-5,5	-0,8	2,7	4,3	1,9	0,3	1,2	0,0	4,1	4,6	4,7	6,9	7,1
Return on assets(1)	-0,3	0,0	0,3	0,5	0,2	0,1	0,1	0,0	0,4	0,4	0,4	0,5	0,5
Total capital ratio	12,3	15,2	15,2	16,7	16,7	17,2	17,6	18,1	17,7	17,8	17,8	19,1	19,3
CET 1 ratio	11,4	13,9	13,2	14,1	14,1	14,6	14,9	15,4	15,2	15,3	15,2	15,8	16,0
Tier 1 ratio	11,7	14,5	13,9	15,2	15,3	15,8	16,0	16,6	16,2	16,3	16,2	16,9	17,1
Loan to deposit ratio	80,8	78,9	76,2	76,4	75,7	72,1	73,1	72,1	70,3	69,7	69,5	83,4	86,5

(1) Annualised data
Source: ECB - CBD2 Consolidated Banking data; own calculations

benefitted in the past from public moratoria schemes, is well above that for total loans. Against this backdrop, a moderate deterioration in asset quality in the medium term cannot be ruled out.

Domestic banks maintained excess liquidity as deposits kept increasing and monetary policy remained accommodative. Albeit at a slower pace compared to 2020, banks' deposits from households and NFCs kept increasing in 2021 and early 2022, totalling over EUR 235 billion by February 2022 (8.8% y-o-y). These, accompanied by cheap central bank funding (representing 9.3% of total assets in end-2021, 1.5 pps. higher y-o-y), allowed banks to further improve their already comfortable funding and liquidity profiles. Hence, at end-2021, the banks' liquidity coverage ratio (LCR) stood at 260% (14 pps. y-o-y increase) and the net stable funding ratio (NSFR) at 144%, both well above the minimum legal thresholds of 100%. This stark increase in liquidity was not mirrored by a corresponding increase in lending, as the loans-to-deposits ratio dropped by 3.5 pps. in 2021, to a new low at 81.2%, and banks boosted their reserves at central banks, up at 14.1% of total assets in Q3-2021 from 8.3% one year earlier. 2021 was also an important year for the issuance of instruments eligible for compliance with the minimum requirement for own funds and eligible liabilities (MREL). Most major institutions in the Portuguese banking system issued MREL eligible debt, in particular preferred and non-preferred senior instruments, totalling EUR 4.375 billion. All lenders met their binding intermediate target on 1 January 2022 and seem well positioned to comply with their targets by the deadline of 1 January 2024.

Notwithstanding banks' limited direct exposures towards Ukraine and Russia, the war carries strong uncertainty for the financial sector. Domestic banks have close to no direct exposures to Russia and Ukraine, but are vulnerable to possibly significant second- and third-round effects. The increase in commodity and energy prices will affect mainly the most energy-intensive sectors, with potentially dire effects on banks' loan books. Likewise, supply chain disruptions and higher costs for consumers might impact consumers' behaviour, reduce economic activity and, at the same time, erode banks' deposit base. Increasing pressures on prices might however accelerate the normalisation of monetary policy. This in turn could benefit the Portuguese lenders, which are strongly reliant on net interest income, notwithstanding the risk of slowdowns in the economic activity.

Residential real estate is growing in both prices and volumes, unaffected by the end of pandemic emergency support measures. Portugal's real estate market remains one of most dynamic in the EU. In a context of low interest rates, mortgage credit was in high demand throughout 2021, though decelerating by the end of the year. The increase in the stock of loans for house purchases accelerated from 3% in June 2021 (y-o-y) to 4.1% in December 2021. This rise resulted from the gradual increment of the average credit amount and, more importantly, from the increasing number of mortgages (+22% in 2021 compared 2020). This trend has gone hand in hand with the growing demand for houses, while the supply of new dwellings continued on a relatively subdued trend compared to the period preceding the sovereign debt crisis, contributing to an upward pressure in prices. This gap has contributed to set an upward pressure on property prices. Statistics Portugal's house prices index suggests that the market is still growing fast with the indicator increasing from 166 in Q2-2021 to 176 in Q4-2021 (2010=100). This dynamism reflects, among others, the availability and low cost of mortgages over recent years. Nevertheless, banks' exposure to real estate as a percentage of total assets has been decreasing since 2016 (34.1% as at December 2021). In January 2022 Banco de Portugal amended the macroprudential recommendation aiming at reinforcing the convergence to 30 years of the average maturity for new mortgage-backed loans. This recommendation has been successful in bringing down the loan to value (LTV) ratio for new housing loans and may help reduce the pace of mortgage lending growth and mitigate related risks going forward.

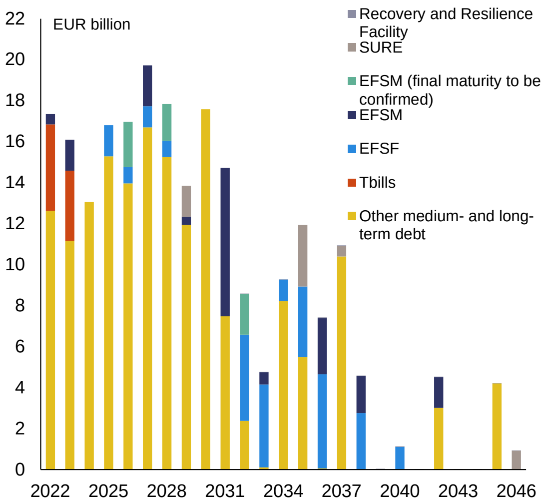
The Portuguese recovery and resilience plan (RRP) provides some tailwind for judicial reforms. The Portuguese RRP includes a component (C18) with measures supporting the transformation of the justice system into a leaner, more agile and digitally advanced judicial system. One of the key targeted areas, often perceived as inefficient and outdated, are insolvency proceedings. The recently approved legislation 9/2022 (in force since 11 April 2022), which also transposes the Insolvency Directive (EU 2019/1023), contains several measures referenced directly in the RRP. Some of the key features included are: (i) the elimination of restrictions on access to the exercise of insolvency administrators and review of judicial administrator's remuneration statute, (ii) the assigning of the Insolvency Administrator to draw up a liquidation plan, with temporally defined goals, for the sale of assets that make up the insolvent estate and (iii) the institution of mandatory partial apportionment whenever the insolvent estate is part of the liquidation of assets with a value higher than EUR 10,000. Other legislative procedures are also scheduled to enter into force in the coming months and are expected to streamline and speed up insolvency processes in Portugal.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Following increases in 2020 and 2021, Portugal's financing needs are expected to lessen as of 2022. The considerable policy response to the COVID-19 crisis necessarily translated into greater financing needs in 2020 and 2021. Crucially, in 2021, this coincided with an increase in debt redemptions by EUR 5.1 billion, compared with 2020, which fully offset the better-than-planned deficit outturn (see Section 3), and caused Portugal's financing needs to expand by EUR 2.2 billion, reaching a peak of EUR 26.7 billion (12.6% of GDP). As deposits became a relevant source of funding in 2021, Portugal's cash buffer – which had reached the historically high level of EUR 23.9 billion (11.9% of GDP) in 2020 – was reduced considerably to EUR 15.6 billion (7.4% of GDP) in that year, while still remaining relatively sizeable. Portugal's financing needs are expected to ease in 2022, when they are planned to decline by EUR 2.7 billion, to EUR 24 billion (10.5% of GDP). The combined projected improvement in the budget balance, the planned reduction in the net acquisition of financial assets, and some contained additional deposit withdrawals are expected to more than compensate for the upward pressure on Portugal's borrowing requirements exerted by another increase in debt redemptions, by EUR 0.7 billion (0.3% of GDP) in 2022. In tune with the expected lower financing needs, Portugal's cash buffer is planned to decrease slightly to EUR 15.1 billion (6.6% of GDP) in 2022, closer to pre-pandemic levels, and still covering more than one-third of the year's borrowing requirements.

Portugal' active debt management strategy has contributed to mitigating challenges. The country continued to seek a smoother debt redemption profile, taking steps to cap forthcoming annual peaks in debt redemptions (see Graph 5.1). Moreover, the improvement in Portugal's public debt structure through liability management operations – such as buy-backs and government bond exchange offers – has succeeded in lengthening the average debt maturity and containing interest expenditure. In recent years, the average residual maturity of Portugal's public debt has remained broadly stable at close to eight years, with an increase expected in 2022, driven by medium- and long-term issuances. The Portuguese public debt issuances continued to be attractive to investors and government bonds remained the country's main funding instrument. Despite elevated market volatility, by the cut-off date of this report Portugal had conducted two syndicated issuances of long-term government bonds in 2022, on 12 January and 6 April, each amounting to EUR 3 billion, with maturities of 20 and 10 years, and coupon rates of 1.15% and 1.65%, respectively. The investor base remained diversified across regions and type of investors, with the Eurosystem and private banks being the main holders of Portuguese government bonds.

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



(1) Last update: 21-04-2022
Source: Portuguese Treasury and Debt Management Agency (IGCP)

Portugal started repaying its financial assistance loan to the European Financial Stabilisation Mechanism (EFSM) in 2022. On 17 October 2019, after having fully repaid its financial assistance loan to the International Monetary Fund by December 2018, Portugal carried out a first prepayment of EUR 2 billion to the European Financial Stability Facility. Subsequently, on 4 April 2022, and observing the conditions set out in the Commission's decision of 26 August 2019 relating to the waiving of the proportionate prepayment clause of the EFSM, which otherwise should have been carried out in parallel with the aforementioned prepayment to the EFSF ([11]), Portugal made a first repayment of

([11]) 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

EUR 0.5 billion to the EFSM. At the same time, EUR 2.2 billion of the EFSM loan amounting to EUR 2.7 billion due on that date was rolled over to 22 October 2026. The schedule of the remaining repayments to the EFSM will continue to be reviewed, in agreement between the Commission and the Portuguese authorities, as well as subject to market conditions, while smoothening the debt redemption profile and avoiding significant peaks in any given year.

The Support to mitigate Unemployment Risks in an Emergency (SURE) helped Portugal finance its policy response to the COVID-19 crisis. On 25 September 2020, the Council, following a Commission proposal, granted to Portugal a loan under SURE for a maximum of EUR 5.9 billion (3% of GDP), in order to help finance public expenditure in relation to short-term work schemes or similar measures, as well as health-related measures, as an ancillary ([12]). Subsequently, on 25 January 2022, the Council, following another Commission proposal, deemed three additional measures eligible for financing under SURE ([13]). The total SURE loan – which has an average maturity of close to 15 years – has already been fully disbursed and absorbed by Portugal, with its third instalment, of EUR 523 million, having been paid out on 29 March 2022. Due to the EU's 'AAA' credit rating and the liquidity of the SURE bonds, the loan has generated interest savings for Portugal – estimated by the Commission services at close to 0.2% of GDP ([14]) – since it offered lower interest rates than those the country would have paid if it had issued sovereign debt on the market.

The Recovery and Resilience Facility is becoming a relevant source of financing. Portugal's recovery and resilience plan (RRP) provides for a total financial contribution of EUR 16.6 billion (about 8% of GDP) by the Recovery and Resilience Facility, including grants (this is, non-repayable support) amounting to EUR 13.9 billion and loans amounting to EUR 2.7 billion. The release of its instalments is conditional on the satisfactory fulfilment by Portugal of the relevant milestones and targets, which should be completed no later than 31 August 2026. On 3 August 2021, a pre-financing of EUR 2.2 billion (1% of GDP), including EUR 1.8 billion in grants and EUR 0.4 billion in loans, and equivalent to 13% of the total financial allocation, was disbursed to Portugal. On 25 March 2022, the Commission endorsed a positive preliminary assessment of Portugal's first payment request for EUR 1.16 billion (0.5% of GDP), including EUR 0.55 billion in grants and EUR 0.61 in loans. The favourable opinion of the Economic and Financial Committee of the Council paved the way for the Commission to adopt a final decision on the disbursement of the funds, in accordance with the examination procedure through a comitology committee. The disbursement of the first payment took place on 9 May 2022. ([15]).

Portugal's public debt-to-GDP ratio resumed its downward trajectory in 2021, supported by the economic recovery. After a peak at 135.2% in 2020, the public debt-to-GDP ratio dropped to 127.4% in 2021. According to the Commission 2022 spring forecast, it is projected to remain on a steadily declining path, decreasing to 119.9% of GDP in 2022, and to below its pre-pandemic level already in 2023. At the same time, the Commission's debt sustainability analysis shows that Portugal faces high fiscal sustainability risks in the medium term (see dedicated Annex). On the one hand, the analysis confirms the unfavourable

Agreement between the Union and the Portuguese Republic, C(2019) 6264 final.

([12]) 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.

([13]) These measures related to safeguarding the livelihoods of artists and cultural workers, as well as of self-employed workers, managers, and employees whose income were severely affected by the COVID-19 pandemic, combined with the hiring of additional health professionals by the National Health Service in order to strengthen its response capacity. Council Implementing Decision (EU) 2022/99 of 25 January 2022 amending Implementing Decision (EU) 2020/1354 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 17, 26.1.2022, p. 47–51.

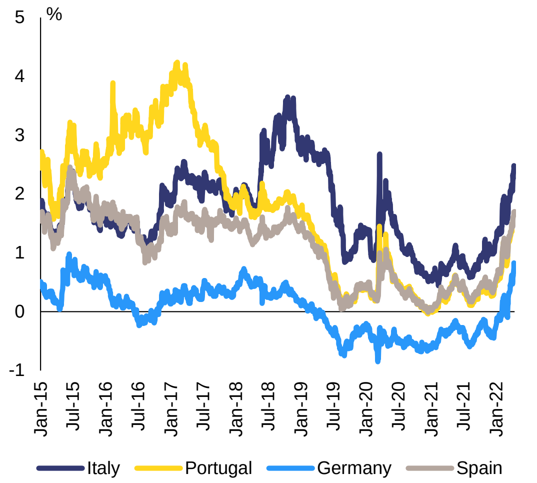
([14]) Report from the Commission to the European Parliament, the Council, the Economic and Financial Committee and the Employment Committee, Report on the European instrument for Temporary Support to mitigate Unemployment Risks in an Emergency (SURE) following the COVID-19 outbreak, pursuant to Article 14 of Council Regulation (EU) 2020/672, COM(2021) 596 final.

([15]) Positive preliminary assessment of the satisfactory fulfilment of milestones and targets related to the first payment request submitted by Portugal on 25 January 2022 (https://ec.europa.eu/info/system/files/c_2022_1999_1_en_annexe_acte_autonome_nlw_part1_v2.pdf).

effect of the projected increase in ageing costs in Portugal. On the other hand, the Commission's baseline scenario projects mostly favourable interest-growth differentials, supported by the growth-enhancing impact of the investments under the Recovery and Resilience Facility in a reasonably low interest rate environment. Importantly, country-specific factors mitigate Portugal's fiscal sustainability challenges, linked to its comfortable cash buffer, the recent lengthening of its debt maturity, its relatively stable financing sources, and the debt's currency denomination. Notwithstanding, the size of public contingent liabilities continues to magnify fiscal sustainability challenges in the medium term.

Portugal's market financing conditions remained favourable at the cut-off date of this report. Since October 2018, and despite the temporary worsening of the country's fiscal outlook on the back of the COVID-19 crisis, the main credit rating agencies have assigned an 'investment' grade to Portugal's public debt. On 25 February 2022, DBRS confirmed Portugal's rating at 'BBB (high)' and upgraded the trends on the long-term rating to 'positive'. The main drivers underpinning this upgrade were the projected strong economic growth on the back of enhanced political stability, the high vaccination rate of the Portuguese population, the potential positive impact of Next Generation EU on the productivity capacity of the Portuguese economy, and the expected decline of the public debt-to-GDP ratio brought by stronger economic growth and the improving fiscal outlook. In addition, the Eurosystem's accommodative monetary policy stance – notably, the set of monetary policy actions undertaken by the ECB in response to the COVID-19 crisis – contributed to preserving Portugal's favourable financing conditions. Partly as a result, the implicit interest rate on Portugal's public debt has attained a continuously declining path for a decade, falling to 1.9% in 2021. After a period of high volatility at the outset of the COVID-19 crisis and a subsequent decline to historically low levels, the Portuguese government bond yields began to increase for all maturities at the end of 2021 (see Graph 5.2). This trend was compatible with stable spreads vis-à-vis Portugal's main European peers.

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



Source: European Commission

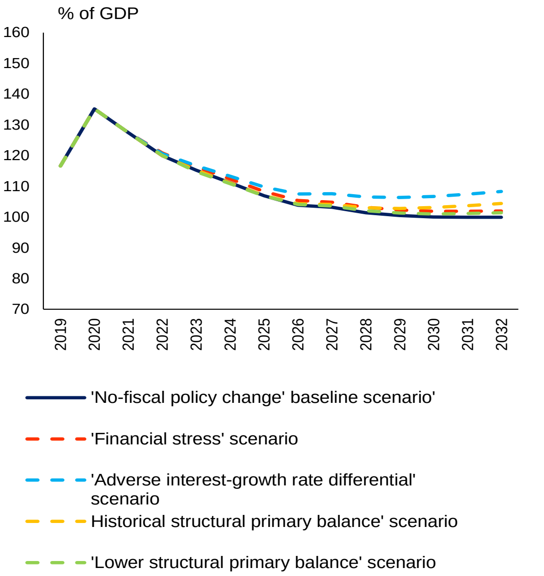
Portugal's sovereign financing and capacity to repay remain sound. Although Portugal's high public debt-to-GDP ratio and inherent vulnerabilities continue to require close and regular monitoring, especially in view of the gradually changing financing conditions, relevant country-specific factors attenuate some of those challenges. In the short term, Portugal's capacity to repay is supported by its diversified government financing sources, the relatively smooth redemption profile of public debt, and a comfortable cash buffer. In the medium to long term, prudent and more growth-friendly fiscal policies, combined with reforms to address structural bottlenecks and boost potential growth, continue to be important to strengthen the sustainability and resilience of Portugal's public finances and the country's capacity to repay.

ANNEX 1
European Commission debt sustainability analysis

The debt sustainability analysis (DSA) uses the Commission 2022 spring 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 2022-2032, relying on alternative assumptions for the development of key variables over the medium term to yield the baseline, a series of alternative deterministic scenarios and stochastic projections. ([16]). After reaching an all-time high in 2020, surging by about 19 pps. to 135.2%, Portugal's public debt-to-GDP ratio started to decrease in 2021, when it dropped to 127.4%. A favourable nominal interest-growth rate differential, on the back of the economic recovery drove the observed decrease. This is compounded by a debt-reducing stock-flow adjustment owing to the reduction of the cash buffer in 2021 and the positive difference between the amount of disbursed grants under the Recovery and Resilience Facility in 2021 – notably, the pre-financing of 13% – and the associated actual spending. According to the Commission 2022 spring forecast, the public debt-to-GDP ratio is projected to continue to decline, decreasing to 119.9% in 2022, and to 115.3% in 2023, below its pre-pandemic level. At the same time, possible challenges to the public debt outlook relate, among others, to the considerable size of public contingent liabilities linked to crisis-related public guarantees, adding to pre-pandemic vulnerabilities.

Portugal is projected to face low fiscal sustainability risks in the short-term. The S0 indicator – an early-detection indicator which evaluates fiscal sustainability risks in the short-term stemming from fiscal and financial-competitiveness variables – is estimated to stand below its critical threshold, indicating low overall short-term vulnerabilities. The Eurosystem's accommodative monetary policy stance – notably, the set of monetary policy actions undertaken by the ECB in response to the COVID-19 crisis – has contributed to maintain favourable financing conditions. In addition, Portugal's cash buffer, of around 7.4% of GDP in 2021, remains relatively sizeable. Gross financing needs are expected to remain large in the short-term, but are projected to decline in 2023.

Graph A1.1: **Deterministic public debt projections under different scenarios**



Source: European Commission

Portugal is projected to face high fiscal sustainability risks in the medium-term. Fiscal sustainability risks in the medium-term are assessed based on the Commission's DSA and the S1 indicator. According to the Commission DSA for Portugal, under a 'no-fiscal policy change' baseline scenario – which assumes a constant structural primary surplus (before ageing costs) of 0.7% of GDP as of 2023 – the public debt-to-GDP ratio is expected to gradually decline, before stabilising at around 100% in the period 2030-2032 (see Graph A1.1). At the same time, the baseline scenario projects a favourable nominal interest-growth rate differential thanks to the growth-friendly impact of Next Generation EU,

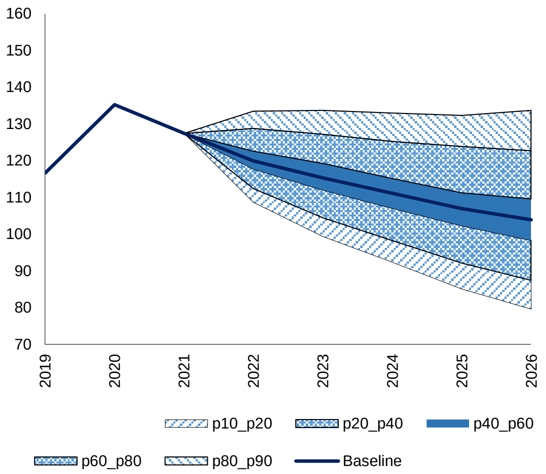
([16]) In detail, the assumptions underlying the Commission's 'no-fiscal policy change' baseline scenario notably comprise: (i) a structural primary surplus, before ageing costs, of 0.7% of GDP as of 2023; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years 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 forward nominal rates by 2032 (as for all Member States); (iv) real GDP growth rates from the Commission 2022 spring forecast until 2023, followed by projections for 2024-2032 (on average slightly below 1%) adjusted for the impact of investment under the Next Generation EU package; (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, November 2020). For information on the methodology, see the Fiscal Sustainability Report 2021 (European Commission, Institutional Paper 171, April 2022).

including the investments under the Recovery and Resilience Facility, in a reasonably low interest rate environment. The S1 indicator – which measures the consolidation effort, in terms of the 5-year cumulative change in the structural primary balance compared to the baseline, needed to reduce the public debt-to-GDP ratio to 60% in 15 years' time – is estimated at 3.7, above its upper critical threshold of 2.5, thereby indicating high fiscal sustainability risks in the medium-term. These results are mainly driven by the high level of Portugal's public debt and, to a lesser extent, the projected increase in ageing costs over the medium term.

Achieving prudent medium-term fiscal positions, when appropriate, remains important. Less fiscal consolidation by 2023 than expected in the Commission 2022 spring forecast, as reflected in the 'lower structural primary balance' scenario – whereby the change in structural balance between 2022 and 2023 is half the one included in the Commission 2022 spring forecast – would lead to a slightly higher public debt-to-GDP ratio than in the baseline, of approximately 1 pp. of GDP by 2032. In the 'historical structural primary balance' scenario – whereby the structural primary balance would gradually converge to its 2006-2020 average of a broadly balanced budget in structural terms, thereby a worsening of the structural primary balance with respect to the baseline scenario – the projected public debt-to-GDP ratio would converge by 2032 to a level 4 pps. above the baseline scenario.

Portugal's public debt-to-GDP ratio remains vulnerable to a worsening of economic and financing conditions. A worsening of financial conditions, as reflected in the 'financial stress' scenario – whereby market interest rates are assumed to increase temporarily by 1 pp. in 2022([17]) –, would lead to a persistent increase of the public debt-to-GDP ratio by around 2 pps. of GDP by 2032, as compared with the baseline scenario. A worsening of the macro-financial conditions, as reflected under the 'adverse interest-growth rate differential' scenario – whereby the differential between market interest rates and nominal GDP growth is permanently 1 pp. higher –, would result in an increase of the public debt-to-GDP ratio by around 8 pps. of GDP by 2032, as compared with the baseline scenario. This adverse scenario illustrates the risk of a reversal of Portugal's favourable nominal interest-growth rate differential.

Graph A1.2: **Stochastic projections for the public debt-to-GDP ratio in the period 2022-2026**



Source: European Commission

Stochastic projections show the sensitivity of Portugal's public debt-to-GDP ratio to shocks. Stochastic simulations – which capture the impact on the baseline scenario of numerous possible shocks on growth, interest rates and the primary balance, based on the historical volatility in the Portuguese economy – show that public debt projections are surrounded by considerable uncertainty (see Graph A2.2)([18]). According to the

([17]) For highly indebted countries such as Portugal, the adverse shock on market interest rates by 1 pp. in 2022 is augmented by a 'risk premium', linked to the debt level in excess of 90% 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.

([18]) Stochastic debt projections allow to assess 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 stochastic simulations, it is probable that the public debt-to-GDP ratio will not decline over the next 5 years, with substantial uncertainty regarding the level of debt in 2026.

Portugal is deemed to face medium sustainability risks in the long term. The long-term sustainability indicator S2, at -1.4, suggests that, relative to the baseline, no consolidation effort is needed to stabilise the public debt-to-GDP ratio over the long-term, especially given the projected decrease in public pension expenditure over that horizon. Combining the S2 indicator with the results of the Commission's DSA leads to the overall assessment of medium fiscal sustainability risks over the long term.

Several factors mitigate Portugal's fiscal sustainability risks. These factors notably relate to Portugal's comfortable cash buffer (see Section 5), the country's stable financing sources – with a diversified and large investors' base –, the continued smoothening of the debt redemption profile, and the debt's currency denomination. Furthermore, the structural reforms under the Recovery and Resilience Facility are expected to have a substantial positive and lasting impact on GDP growth. 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.

the 60th percentiles) includes the 20% of all possible debt paths that are closer to the baseline

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	4.5	4.6	2.3
2. Government consumption expenditure	0.4	4.1	1.2	1.3
3. Gross fixed capital formation	-2.7	6.4	6.5	5.2
4. Final domestic demand	**-5.0**	**4.8**	**4.4**	**2.7**
5. Change in inventories	--	--	--	--
6. Domestic demand	**-5.5**	**5.0**	**4.4**	**2.7**
7. Exports of goods and services	-18.6	13.1	12.3	4.1
7a. - of which goods	-7.8	10.6	2.4	2.9
7b. - of which services	-36.9	19.2	35.3	6.1
8. Final demand	**-9.6**	**7.2**	**6.7**	**3.1**
9. Imports of goods and services	-12.1	12.9	8.6	4.1
9a. - of which goods	-9.4	11.7	6.7	3.9
9b. - of which services	-23.7	18.6	16.9	4.7
10. Gross domestic product at market prices	**-8.4**	**4.9**	**5.8**	**2.7**
Contribution to change in GDP				
11. Final domestic demand	-5.0	4.9	4.5	2.8
12. Change in inventories + net acq. of valuables	-0.6	0.2	0.0	0.0
13. External balance of goods and services	-2.9	-0.2	1.3	-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	9.3	4.3
2. Government consumption expenditure	5.1	4.7	4.2	3.8
3. Gross fixed capital formation	-1.6	9.6	10.7	7.2
4. Final domestic demand	**-3.6**	**6.3**	**8.6**	**4.8**
5. Change in inventories	--	--	--	--
6. Domestic demand	**-4.3**	**6.5**	**8.7**	**4.8**
7. Exports of goods and services	-20.6	19.8	17.9	5.1
8. Final demand	**-9.2**	**10.1**	**11.3**	**4.9**
9. Imports of goods and services	-15.1	21.4	16.9	3.0
10. Gross national income at market prices	-5.7	6.0	8.2	6.0
11. Gross value added at basic prices	-6.1	4.7	9.1	5.8
12. Gross domestic product at market prices	**-6.7**	**5.6**	**8.8**	**5.9**
Nominal GDP, EUR bn	200.1	211.3	229.9	243.4

Table 3: Implicit price deflators

% change in implicit price deflator	2020	2021	2022	2023
1. Private consumption expenditure	0.7	1.2	4.5	2.0
2. Government consumption expenditure	4.7	0.6	2.9	2.5
3. Gross fixed capital formation	1.1	3.0	3.9	1.9
4. Domestic demand (incl. inventories)	**1.4**	**1.4**	**4.1**	**2.0**
5. Exports of goods and services	-2.2	5.9	5.0	1.0
6. Final demand	**0.4**	**2.7**	**4.4**	**1.7**
7. Imports of goods and services	-3.4	7.6	7.7	-1.0
8. Gross domestic product at market prices	**1.9**	**0.7**	**2.9**	**3.1**
HICP	**-0.1**	**0.9**	**4.4**	**1.9**

Table 4: Labour market and cost

Annual % change	2020	2021	2022	2023
1. Labour productivity (real GDP per employee)	-6.7	2.8	4.8	1.7
2. Compensation of employees per head	2.0	3.8	4.2	2.6
3. Unit labour costs	**9.3**	**1.0**	**-0.6**	**0.8**
4. Total population	0.1	0.0	0.0	0.0
5. Population of working age (15-74 years)	0.1	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 (%	**7.0**	**6.6**	**5.7**	**5.5**

Table 5: External balance

levels, EUR bn	2019	2020	2021	2022
1. Exports of goods (fob)	52.1	62.1	67.4	70.0
2. Imports of goods (fob)	65.0	77.7	90.2	92.2
3. Trade balance (goods, fob/fob) (1-2)	**-12.9**	**-15.6**	**-22.8**	**-22.2**
3a. p.m. (3) as % of GDP	**-6.4**	**-7.4**	**-9.9**	**-9.1**
4. Exports of services	22.0	26.7	37.3	40.1
5. Imports of services	13.3	17.4	21.0	22.3
6. Services balance (4-5)	**8.7**	**9.3**	**16.3**	**17.8**
6a. p.m. 6 as % of GDP	**4.3**	**4.4**	**7.1**	**7.3**
7. External balance of goods & services (3+6)	**-4.2**	**-6.3**	**-6.5**	**-4.4**
7a. p.m. 7 as % of GDP	**-2.1**	**-3.0**	**-2.8**	**-1.8**
8. Balance of primary incomes and current transfers	1.7	4.1	2.7	2.8
8a. - of which, balance of primary income	-3.1	-2.4	-4.0	-4.0
8b. - of which, net current Transfers	4.9	6.5	6.7	6.8
8c. p.m. 8 as % of GDP	0.9	1.9	1.2	1.2
9. Current external balance (7+8)	**-2.5**	**-2.3**	**-3.8**	**-1.6**
9a. p.m. 9 as % of GDP	**-1.2**	**-1.1**	**-1.7**	**-0.7**
10. Net capital transactions	2.2	3.8	4.5	5.4
11. Net lending (+)/ net borrowing (-) (9+10)	**-0.3**	**1.5**	**0.7**	**3.8**
11a. p.m. 11 as % of GDP	**-0.2**	**0.7**	**0.3**	**1.6**

Table 6: Fiscal accounts

	2020	2021	2022	2023
% of GDP				
Taxes on production and imports	14.6	15.3	15.0	15.1
Current taxes on income, wealth, etc.	10.1	9.7	9.5	9.6
Social contributions	12.8	12.8	12.4	12.1
Sales and other current revenue	5.7	6.3	5.8	5.7
Total current revenue	**43.2**	**44.2**	**42.8**	**42.5**
Capital transfers received	0.3	1.1	1.4	1.6
Total revenue	**43.5**	**45.3**	**44.2**	**44.1**
Compensation of employees	12.0	11.8	11.3	11.1
Intermediate consumption	5.7	5.8	5.6	5.4
Social transfers in kind via market producers	2.1	2.0	2.0	1.9
Social transfers other than in kind	18.0	17.6	16.7	16.3
Social payments	20.1	19.6	18.7	18.3
Interest paid	2.9	2.4	2.2	2.2
Subsidies	1.8	2.0	0.9	0.6
Other current expenditure	2.5	2.7	2.8	2.7
Total current expenditure	**45.0**	**44.4**	**41.4**	**40.3**
Gross fixed capital formation	2.2	2.5	3.1	3.4
Other capital expenditure	2.1	1.3	1.6	1.4
Other (residual)	4.6	4.0	4.4	4.1
Interest expenditure	2.9	2.4	2.2	2.2
Total expenditure	**49.3**	**48.1**	**46.1**	**45.1**
General government balance (ESA2010)	**-5.8**	**-2.8**	**-1.9**	**-1.0**
Primary balance	-2.9	-0.4	0.3	1.2
% change				
Taxes on production and imports	-9.1	10.6	7.0	6.1
Current taxes on income, wealth, etc.	-3.7	2.2	6.5	6.9
Social contributions	1.0	6.0	5.0	3.5
Sales and other current revenue	-5.1	16.5	0.4	3.8
Total current revenue	**-4.5**	**8.1**	**5.4**	**5.2**
Capital transfers received	-15.9	253.6	34.3	17.8
Total revenue	**-4.6**	**10.0**	**6.1**	**5.6**
Compensation of employees	3.4	4.0	4.0	4.2
Intermediate consumption	2.6	8.1	4.7	2.2
Social transfers in kind via market producers	1.2	0.7	7.4	2.2
Social transfers other than in kind	4.2	3.0	3.5	3.4
Social payments	3.8	2.8	3.9	3.3
Interest paid	-8.4	-10.8	-0.9	5.9
Subsidies	298.6	15.2	-51.9	-26.3
Other current expenditure	6.4	16.3	10.4	4.1
Total current expenditure	**6.0**	**4.1**	**1.6**	**2.9**
Gross fixed capital formation	14.0	19.0	33.5	18.0
Other capital expenditure	96.1	-36.7	36.2	-7.6
Total expenditure	**8.5**	**3.0**	**4.2**	**3.6**
Nominal GDP, EUR bn	**200.1**	**211.3**	**229.9**	**243.4**

Table 7: Government debt developments

	2020	2021	2022	2023
ESA2010 government balance (% of GDP)	**-5.8**	**-2.8**	**-1.9**	**-1.0**
ESA2010 gross debt (% of GDP)	135.2	127.4	119.9	115.3
ESA2010 government balance	**-11.7**	**-6.0**	**-4.4**	**-2.5**
Gross debt	270.5	269.2	275.8	280.5
Change in gross debt	20.5	-1.2	6.5	4.7
Nominal GDP	200.1	211.3	229.9	243.4
Real GDP growth (% change)	**-8.4**	**4.9**	**5.8**	**2.7**
Change in gross debt (% of GDP)	10.2	-0.6	2.8	1.9
Stock-flow adjustments (% of GDP)	4.4	-3.4	0.9	0.9
Gross debt ratio	**135.2**	**127.4**	**119.9**	**115.3**
Change in gross debt ratio	18.6	-7.8	-7.5	-4.7
Primary balance	-2.9	-0.4	0.3	1.2
"Snow-ball" effect	11.2	-4.7	-8.1	-4.4
of which				
Interest expenditure	*2.9*	*2.4*	*2.2*	*2.2*
Real growth effect	*10.8*	*-6.3*	*-7.0*	*-3.1*
Inflation effect	*-2.4*	*-0.9*	*-3.3*	*-3.5*
Stock-flow adjustments	**4.4**	**-3.4**	**0.9**	**0.9**
Implicit interest rate	*2.3*	*1.9*	*1.9*	*2.0*

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