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Post-Programme Surveillance Report

Portugal, Autumn 2020

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Autumn 2020

EUROPEAN ECONOMY

Institutional Paper 138

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This report reflects information available up until 11 October 2020.

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([1]) The executive summary of this report was adopted as Commission Communication C(2020)8042 on 16 November 2020. The rest of the report reflects the findings of the Staff Working Document (SWD(2020)281) 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

ACE	Allowance for Corporate Equity
BdP	Banco de Portugal
BFL	Budgetary Framework Law
CET1	Common Equity Tier 1
CGD	Caixa Geral de Depósitos
CIT	Corporate Income Tax
DBP	Draft Budgetary Plan
DGO	Directorate-General for Budget
DSA	Debt Sustainability Analysis
EC	European Commission
ECB	European Central Bank
EDP	Energias de Portugal
EPC	Economic Policy Committee
EPL	Employment Protection Legislation
ESM	European Stability Mechanism
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
HICP	Harmonised Index of Consumer Prices
IGCP	Portuguese Treasury and Debt Management Agency
IMF	International Monetary Fund
IMPIC	Institute for Monitoring Public Procurement
INE	Portugal's National Statistical Office
MIP	Macroeconomic Imbalance Procedure
MTO	Medium-term Budgetary Objective
NFCs	Non-financial Corporations
NPLs	Non-performing Loans
OECD	Organisation for Economic Co-operation and Development
PER	Special Revitalisation Process for Enterprises
PIT	Personal Income Tax
PPS	Post-programme Surveillance
PPP	Public-private Partnership
q-o-q	Quarter on quarter
RoE	Return on Equity
RoA	Return on Assets
SGP	Stability and Growth Pact
SMEs	Small- and Medium-sized Enterprises
SOEs	State-owned Enterprises
ULC	Unit Labour Costs
VAT	Value-added Tax
y-o-y	Year on year

EXECUTIVE SUMMARY

This report presents the findings of the twelfth 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 7 to 14 September 2020. Since the conclusion of the eleventh post-programme surveillance mission in February 2020, Portugal's economic performance, in line with developments in the EU and the rest of the world, suffered a sudden shock caused by the outbreak of the COVID-19 pandemic. The shock was particularly strong in the second quarter of 2020. Most economic activities started to recover in the third quarter of the year but many sectors, particularly the country's large hospitality industry, are not expected to reach their pre-crisis levels before 2022. However, despite some volatility at the beginning of the pandemic, financing conditions for Portugal remained favourable.

Following a strong performance until February 2020, the Portuguese economy witnessed a sharp reversal in March driven by the spread of the COVID-19 pandemic and the measures taken to control it. Consequently, Portugal's GDP dropped by 2.3% y-o-y in Q1-2020 and 16.3% y-o-y in Q2-2020. Due to the country's large exposure to tourism, the economic contraction in Portugal was slightly larger than the average for the EU. The country's external balance worsened as well, although the large drop in travel receipts was partly offset by the improved balance of trade in goods. Economic activity started to recover in the summer period. Most of the sectors witnessed a V-shaped recovery but the hospitality industry remained well below its pre-crisis level. Overall, with GDP growth rates of -9.3% in 2020 and 5.4% in 2021, economic activity is not projected to reach pre-crisis levels before 2022, and uncertainties remain high.

The labour market has been less affected, thanks to government support schemes. Unemployment increased only moderately from 6.5% in 2019 to around 8% until August 2020. However, labour utilisation dropped significantly due to reduced working hours and increased inactivity. The exit from these support measures should be gradual, to help avoid cliff-edge risks on the labour market and to help employability and transition to viable jobs, while supporting a comprehensive recovery.

Public finances provided significant stabilisation, resulting in a worsened budgetary outlook. Starting from a surplus of 0.1% of GDP in 2019, the general government budget balance is projected to turn into a sizeable deficit of 7.3% of GDP in 2020. Similarly, while the general government debt-to-GDP ratio had been on a steady downward path, declining to 117.2% in 2019, a rise to 135.1% of GDP is now projected for 2020. The operation of the automatic stabilisers and the budgetary impact of the policy measures taken to cushion the socio-economic consequences of the COVID-19 pandemic are the driving forces for the worsened budgetary outlook. Fiscal-structural reforms remain key to strengthen expenditure control and cost efficiency, address the factors contributing to the accumulation of arrears in hospitals during recent years and tackle fragilities in state-owned enterprises. These would also help Portugal maximising the impact of European support from the Next Generation EU package.

The Portuguese banking system proved to be more resilient at the start of the pandemic than at the outset of the global financial crisis a decade ago, notwithstanding the vulnerabilities inherited from the latter. Policy measures such as loan moratoria softened the initial impact of the pandemic on the financial system on the one hand, while on the other ensuring that it did not amplify the adverse economic impact. As the pandemic is still unfolding, the ultimate economic impact will only become visible with a delay, in particular once moratoria expire. An increase in credit risk could eventually translate into rising impairments, which would put further pressure on profitability, and a deterioration in asset quality in the form of an increasing non-performing loan ratio. In the light of a possible increase in insolvencies, it is important that banks and authorities prepare to address those risks.

Financing conditions and the capacity to repay remain sound, but require close monitoring in view of the challenges arising with the COVID-19 crisis. Active debt management had smoothened the debt redemption profile and helped reduce interest costs, thereby moderating vulnerabilities. Market financing conditions remain favourable to date. Nonetheless, the sharp increase in public debt came on top of the high pre-crisis level, temporarily halting debt reduction. Moreover, public contingent liabilities are on the rise, stemming from some public corporations and the private sector, including through the possible calling of State guarantees. A return to lower and more prudent debt levels may therefore take some time.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the twelfth post-programme surveillance (PPS) mission to Portugal between 7 and 14 September 2020. Due to travel restrictions imposed during the COVID-19 pandemic, the mission took place in the form of online video meetings. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. The mission was coordinated with an IMF staff visit. PPS monitors economic, fiscal and financial conditions to assess the repayment capacity of a country that has received financial assistance[3]. While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

The current PPS reporting focused on the most relevant macro, fiscal and financial developments. Structural reforms in the real sector were analysed only in their macroeconomic context. The objective is to minimise overlaps with work and reporting in the framework of the European Semester.

The outbreak and spread of the COVID-19 pandemic is having an unprecedented impact on the economic and fiscal developments in Portugal as in all other EU Member States. The Portuguese government reacted to COVID-19, mainly on 12 March, with a comprehensive package of measures, addressing the immediate health policy challenges and implementing social distancing measures. The package included as well measures to counter the negative economic impact of COVID-19, e.g. guarantee programmes for affected companies and income support measures. The policy response is being continuously adjusted to the epidemic, economic and social developments. The economic and fiscal impact of all these measures depends on the duration and the magnitude of disruption at global and regional levels. This extraordinary situation creates substantial uncertainties over data reporting and forecasting. Therefore, certain economic indicators and evaluations may differ substantially at the time of the release of the report relative to the cut-off date of 11 October 2020 for drafting the report.

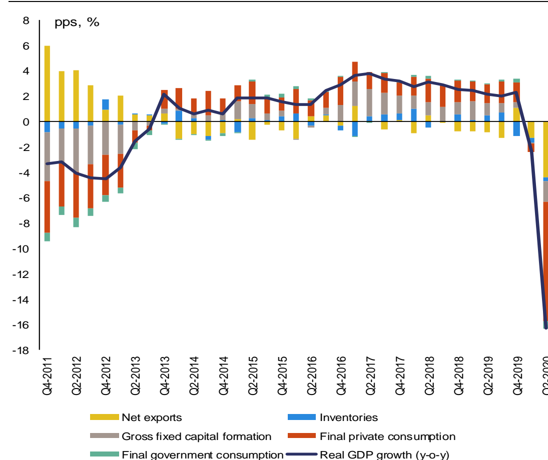
(3) PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Portugal's economic activity declines steeply with the outbreak of the COVID-19 pandemic. Following a strong performance until February 2020, the spread of COVID-19 in Europe and globally brought an abrupt reversal in almost all relevant economic indicators in Portugal and its trading partners. Portugal's GDP contracted by 2.3% y-o-y in Q1-2020 and 16.3% y-o-y in Q2-2020 as the magnitude of the shock exceeded significantly the one from the previous big crisis in 2009. The country's large hospitality sector, particularly activities related to foreign tourism, suffered the most significant decline with the number of airport passengers falling by more than 90% in Q2-2020 (y-o-y). Among the main economic sectors, only construction retained positive growth rates in the first half of the year. On the demand side, export of services and investment in equipment recorded the largest drops but private consumption also fell significantly amid a steep rise in precautionary savings.

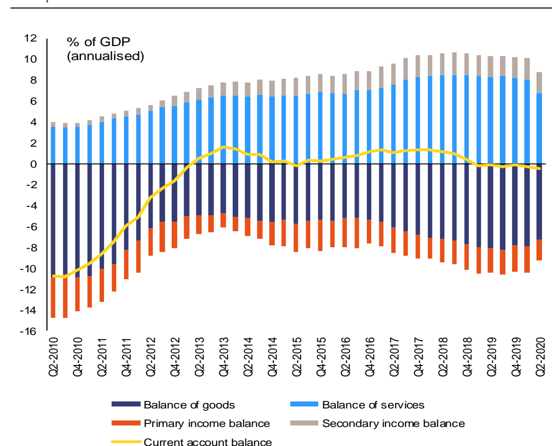
Graph 2.1: **Real GDP growth and components**



Source: Eurostat

The Portuguese economy showed good signs of recovery in Q3-2020 with the gradual relaxation of anti-pandemic measures. Apart from the hospitality industry, most of the business sectors witnessed a substantial recovery in the summer months though many of them remained below the pre-crisis level. Activities related to foreign tourism were still more than 70% below the level from a year earlier and the new spike of COVID-19 infections in September brought a further weakening in the aviation sector, which is a key factor for the tourism industry in Portugal. This has accordingly slowed the pace of recovery. According to the Commission 2020 autumn forecast, GDP is expected to drop by 9.3% this year and to recover only partially by 5.4% in 2021. The balance of risks is tilted to the downside due to the country's large exposure to foreign tourism where significant uncertainties remain in place.

Graph 2.2: **Current account balance**



Source: Banco de Portugal

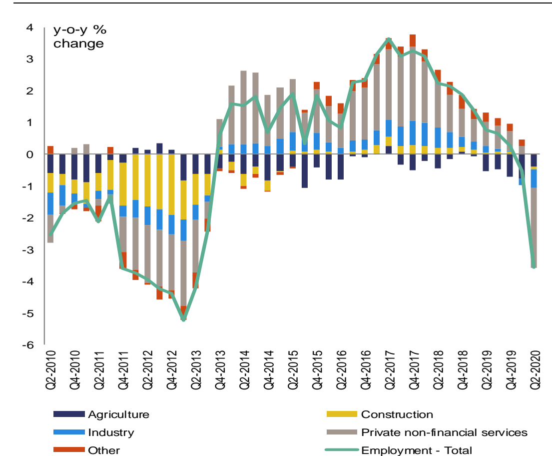
The current account (CA) remained broadly balanced in annualised (12-month) terms until March 2020 but started to worsen with the outbreak of COVID-19. In the first half of 2020, the CA moved to a deficit of 3.2% of GDP relative to 2.2% a year earlier, according to balance of payments data. The surplus in trade with services contracted to 3.6% from 6.8% for the same period, reflecting the huge drop in travel receipts. In net terms, travel receipts declined by EUR 3.0bn (59%) to EUR 2.1bn and the negative impact is likely to exceed EUR 6.0bn (3% of GDP) on full-year basis due to the weak recovery in foreign tourist visits. On the other hand, reduced deficits in trade with goods and primary income offset about two thirds of the negative impact from tourism while the balance in secondary income, including migrant remittances, remained broadly stable. The balance of goods benefited from the positive terms of trade, due to the drop in crude oil prices, and the steep decline in imports of investment goods. The improvement in net primary income was largely due to lower dividend payments to non-residents.

The net international investment position (NIIP) deteriorated from -100.8% of GDP at the end of 2019 to -103.2% as of end-June 2020. However, the deterioration was fully driven by the contraction in GDP for the same period while, in absolute terms, the NIIP improved by EUR 1.9bn in the first half of the year. The impact from net external flows was still negative, as the CA deficit was only partly offset by capital inflows, but net external liabilities benefited from significant valuation effects of about EUR 6bn. This was largely due to the increase in the monetary gold value and the decrease in domestic stock prices, which reduced the FDI-part of the NIIP as well as liabilities related to portfolio holdings of domestic stocks. With the expected economic recovery, the valuation effects linked to stock market moves are likely to reverse, while the NIIP ratio would benefit from the expected gradual recovery in tourism and GDP.

The unemployment rate increased from an annual average of 6.5% in 2019 to around 8% in August 2020. Employment decreased by around 3% y-o-y as of August but part of its negative impact on unemployment was offset by a shift to inactivity. This process was particularly strong during the lockdown in March to May when unemployment even dropped slightly, according to the labour force surveys. At the same time, the number of registered unemployed increased significantly, implying certain statistical discrepancies due to the complexity of the situation where many persons were constrained by confinement and were forced into temporary paid or unpaid leaves. Therefore, the full shock is better illustrated by the steep rise in labour underutilisation, which entails a massive fall of 23.6% y-o-y in hours worked in Q2-2020. Accordingly, labour productivity fell by 13.2% in terms of output per employee but increased by 9.6% per hours worked.

Social measures significantly cushioned the negative impact on the labour market. The measures designed to protect jobs were largely effective in avoiding a much bigger rise in unemployment. About 750,000 employees or nearly 15% of the labour force benefited from various temporary forms of state support at the height of the crisis. Wage support was channelled mainly through employers and entailed compensations for temporary reduction of working hours or furloughs, mostly from March to July, and support schemes for resumption and normalisation of activity as of August. If measures are maintained, they should be regularly adjusted to the labour market conditions and social challenges. The exit from these support measures should be gradual, to help avoid cliff-edge risks while supporting a comprehensive recovery. Authorities expressed commitment to this approach and are entitled to loans for a maximum of EUR 5.9 billion under the EU programme for temporary Support to mitigate Unemployment Risks in an Emergency (SURE).

Graph 2.3: **Employment evolution by sectors**



Source: Eurostat

The Harmonised Index of Consumer Prices (HICP) eased significantly in early 2020 due to the sharp decline in energy prices. The situation was further exacerbated by the disinflationary impact of the lockdown and the headline inflation turned negative. Following the gradual lifting of the social distancing measures, inflation slightly picked up in June 2020, driven mainly by the sharp increase in food prices. However, despite the government's support to households which cushioned the shock to purchasing power, consumer spending remained subdued amid weak consumer confidence, and headline inflation dropped again below zero. The disinflationary pressure from the weak aggregate demand is also visible in core inflation, which also fell into negative territory.

Inflation is likely to return only gradually. In the near term, low oil prices, weak consumer confidence and aggregate demand are set to keep

inflation low. Thereafter, measures applied to contain the epidemic are reducing the economy's production capacity and a recurrence of supply-chain disruptions may result in inflationary pressures, especially in the prices of some products like food and pharmaceuticals. Consequently, headline inflation is forecast to remain subdued in 2020 and gradually rebound in 2021 in line with the expected economic recovery and the projected dynamics in energy prices.

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

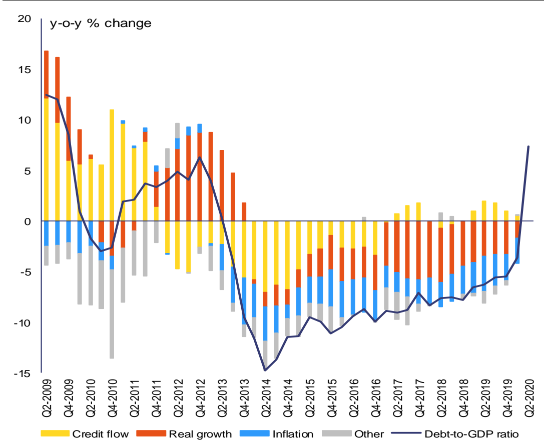
Source: Eurostat

The real estate market remained resilient while property price growth slowed. House prices grew by 7.8% y-o-y in Q2-2020 in nominal terms, decelerating from 8.9% in 2019 and 10.3% in Q1-2020. In q-o-q terms, house prices grew marginally by 0.8%. The continuous rise in residential real estate prices observed since the end of 2013, had also led to a sustained increase of both prices-to-income and prices-to-rent ratios to 128.2% and 137% in Q1-2020, respectively. This reflected primarily the dynamics in tourism and investments by non-residents prior to the crisis, as the domestic market did not witness a comparable increase in new mortgages. Several factors point to a further slowdown in house price growth in the near term. Investment in residential construction continued to increase in the first half of 2020 and market supply is likely to gradually catch up with demand. Additionally, the drop in tourism activities will put further downward pressure on prices, as the short-term rentals market is unlikely to return to its pre-pandemic levels soon.

2.2. PRIVATE DEBT

The unexpected crisis has highlighted the importance of deleveraging observed in recent years. Both households and non-financial corporations have contributed to the downward trend of private debt and private indebtedness dropped fast, falling from the peak of 210.6% of GDP in 2012 to 149.4% of GDP at the end of 2019. This has provided the private sector with an increased capacity to absorb losses and to partly mitigate the adverse economic shock of the pandemic.

Graph 2.5: **Private indebtedness growth and components**



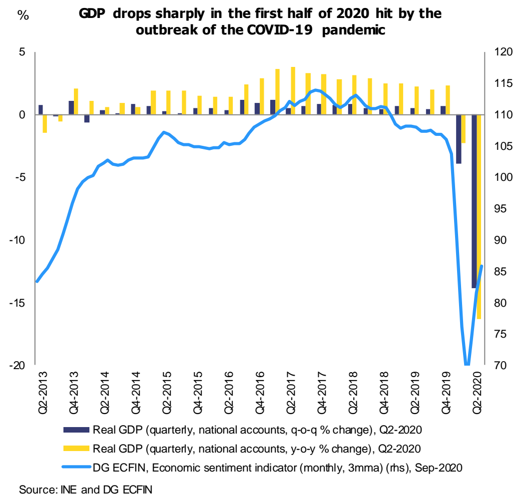
Source: Eurostat, Banco de Portugal

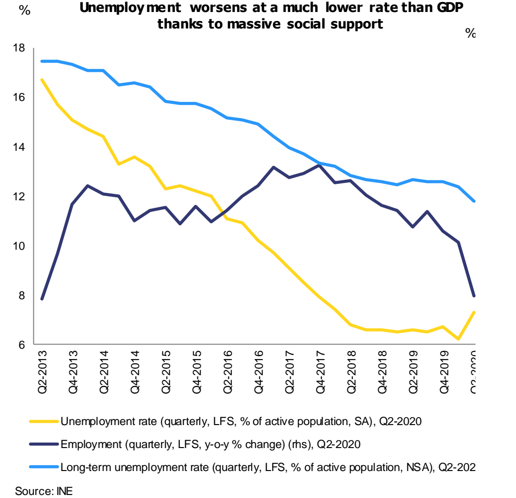
Private indebtedness is set to increase significantly, thus interrupting the deleveraging observed since 2012. Following the government's extraordinary measures to safeguard business continuity (e.g. state-guaranteed credit lines and credit moratoria), the stock of private debt increased by 1.7% y-o-y (EUR 3.7 billion) as of July 2020. With the projected slowdown in economic activity, the pattern of passive deleveraging is expected to come to a halt and the indebtedness ratios to rise considerably. Non-consolidated data of Banco de Portugal show that the private debt-to-GDP ratio soared by 9.5 pps in the first half of 2020, with the largest increases observed in manufacturing, construction and professional services.

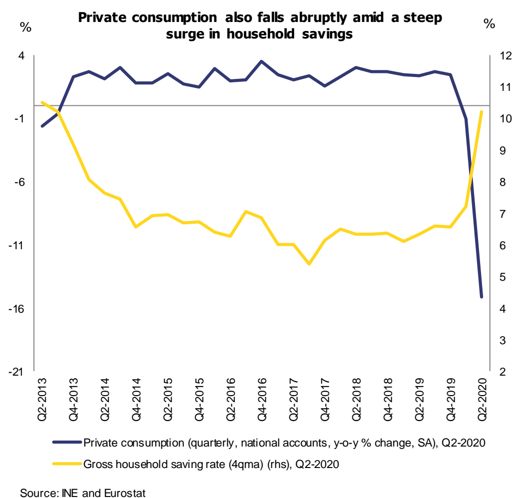
On the positive side, the substantial increase of deposits could act as a safety net against future unfavourable developments. As of July 2020, the stock of private deposits increased by 8.7% y-o-y

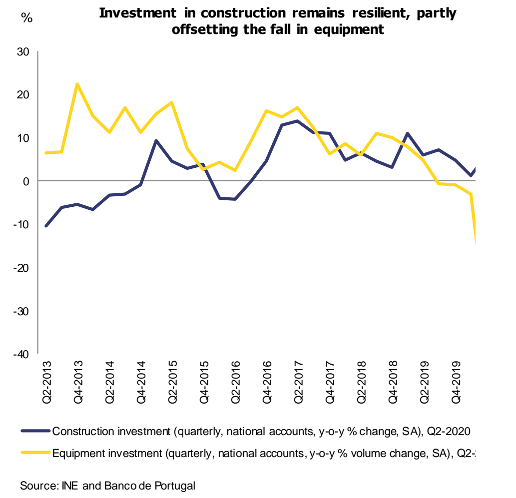
(EUR 16.5 billion), with both households' and corporates' deposits growing at a fast pace, helped by precautionary savings. This provides the private sector with a liquidity buffer to face potential financial problems in the short term. However, these dynamics in aggregate terms might still be hiding solvency problems in individual firms, particularly those in sectors severely hit by the pandemic.

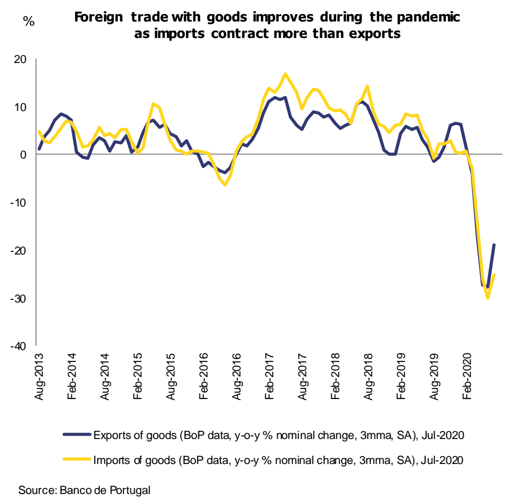
Graph 2.6: **Economic developments**

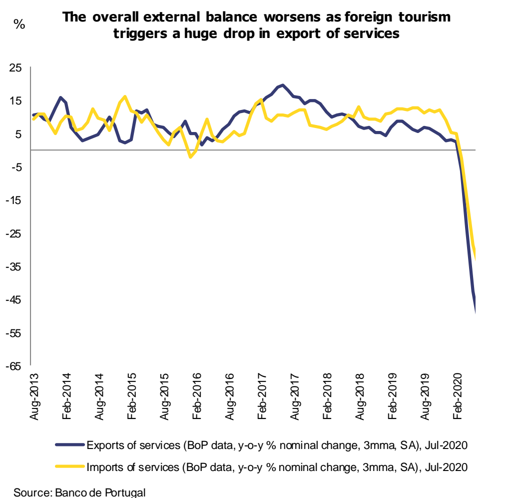












Source: European Commission

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE AND OUTLOOK

The general government budget balance in 2019 reached a surplus for the first time in decades. It improved by 0.4 percentage points, from a deficit of 0.3% of GDP in 2018, to a surplus of 0.1% in 2019 (Table 3.1). Continuously decreasing interest expenditure contributed to that result, having fallen by 0.4 percentage points in 2019, to 3% of GDP. At the same time, the general government primary budget balance – this is, the general government budget balance excluding interest expenditure – remained broadly stable in 2019, at a surplus of 3.1% of GDP. Total government revenue increased by 3.6% y-o-y in 2019 – slightly below nominal GDP growth – supported by the performance of social contributions, taxes on production and imports, and property income.([4]) Total government primary expenditure increased by 3.5% y-o-y, on the back of higher spending on social transfers, including pensions, wages and, to a lesser extent, intermediate consumption. Public investment continued to increase in 2019 from a low base by 5.9% y-o-y, reaching 1.9% of GDP and, thereby, remaining significantly below the average level in the euro area (2.8% of GDP). Portugal's general government budget balance in 2019 continued to be affected by one-off measures – this is, measures that are intrinsically non-recurrent – namely the second activation of the Novo Banco contingent capital mechanism amounting to EUR 1,149 million (0.5% of GDP). Excluding the impact of one-off measures, Portugal would have achieved a surplus of 0.7% of GDP in 2019. The general government debt-to-GDP ratio continued to decline to 117.2% in 2019, reflecting the debt-reducing contributions of the above-mentioned primary surplus and the favourable differential between interest rates and nominal GDP growth.

The COVID-19 outbreak has put Portugal's public finances in 2020 under strain. With fiscal policy being called to provide significant support, the general government budget balance in the first half of 2020 reached a deficit of 5.4% of GDP. For the whole year, the Commission 2020 autumn forecast projects the general government budget balance to deteriorate further to a deficit of 7.3% of GDP. This deterioration is driven by the operation of the automatic stabilisers and the direct budgetary impact of the policy measures taken by the government to tackle the COVID-19 pandemic. Likewise, the general government debt-to-GDP ratio is forecast to spike to 135.1% in 2020. The COVID-19 crisis led to the adoption, during the summer, of a Supplementary State Budget for 2020. The government target for the budget balance in 2020 was thereby revised from a surplus of 0.2% of GDP in the State Budget adopted earlier in February, to a deficit of 7.0% of GDP, which was deemed consistent with an increase of the debt-to-GDP ratio to 133.8%.

In response to the COVID-19 outbreak, Portugal is implementing a multipronged package of policy measures with direct budgetary impact. First, policy measures were taken to reinforce the response capacity of the health system. In the year to August 2020, around 0.2% of GDP were spent on such health-related measures, notably on the purchase of personal protective equipment, ventilators, as well as staff reinforcements and additional working hours in the health system. Second, various policy measures were taken to preserve jobs, provide adequate social support and safeguard firms' business continuity. In the year to August 2020, around 1% of GDP were spent with regard to this wide-ranging package of policy measures. Among these, the temporary interruption of work or reduction of normal working time (commonly designated as "simplified lay-off" in Portugal) and the related exemption from employer's Social Security contributions have been the most prominent measures (0.6% of GDP in the year to August 2020).([5]) Third, against the background of the easing of restrictions over the summer, new policy measures, in force as of July 2020, were geared towards helping firms resume their normal level of activity. While the take-up of the dedicated support

([4]) Compared with 2018, property income increased by EUR 389.3 million in 2019 (26.7% y-o-y), reflecting the dividends paid by Caixa Geral de Depósitos (EUR 200 million) and an increase in those paid by Banco de Portugal (by EUR 119.4 million).

([5]) In its original design, it provided a benefit to eligible firms to cover 70% of the employees' compensation, with employees' compensation equalling two-thirds of their normal gross wage, as well as the exemption from the employer's Social Security contributions. Eligible firms should have suspended their business activity or experienced revenue losses of at least 40%.

Table 3.1: **Fiscal adjustment 2012-2022**

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Budget balance	-6.2	-5.1	-7.4	-4.4	-1.9	-3.0	-0.3	0.1	-7.3	-4.5	-3.0
Budget balance, net of one-offs	-6.1	-5.4	-3.5	-3.2	-2.3	-0.9	0.3	0.7	-6.7	-4.7	-3.0
Structural balance	-3.9	-3.1	-1.8	-2.3	-2.1	-1.8	-1.3	-1.4	-3.3	-3.3	-2.6
Primary balance	-1.3	-0.3	-2.5	0.1	2.2	0.8	3.0	3.1	-4.4	-1.8	-0.5
Structural primary balance	0.9	1.7	3.1	2.3	2.1	2.0	2.0	1.6	-0.3	-0.6	-0.1
Fiscal adjustment	3.5	0.7	1.4	-0.8	-0.2	-0.1	0.1	-0.4	-1.9	-0.3	0.6
Fiscal effort	3.0	0.8	1.4	-0.5	0.2	0.2	0.5	0.0	-1.9	0.0	0.7

([1]) Fiscal adjustment is measured as the change in the structural primary balance; fiscal effort is defined as the change in the structural balance.

Source: European Commission 2020 autumn forecast

scheme for the resumption of business activity appears to be somewhat limited, making the first and second advanced payments under the Corporate Income Tax not mandatory this year is expected to lead to a sizeable loss in government revenue (0.6% of GDP in 2020).

In addition to policy measures with direct budgetary impact, Portugal is supporting firms through ancillary 'liquidity measures'. The most important of these has been a publicly guaranteed scheme for investment and working capital loans granted by commercial banks, for which Portugal sought and obtained approval by the Commission in the context of the State aid Temporary Framework([6]) for a maximum of EUR 13 billion (6.6% of GDP). Overall, publicly guaranteed credit lines were created for EUR 7.9 billion (around 4% of GDP) in the year to August 2020, accessible namely to small- and medium-sized enterprises, as well as firms facing difficulties as a result of the COVID-19 crisis, in particular those performing accommodation and food service activities.([7]) A new credit line has been launched on 30 September, which is available to small and mid caps, as well as medium-sized enterprises, that have not yet benefited from the credit lines developed against the background of the COVID-19 outbreak. Such public guarantees constitute contingent liabilities for the government and may negatively impact the budget balance in the amount that they are eventually called on. Portugal also deferred towards the second half of 2020 a number of firms' tax and contributory obligations, including two-thirds of Social Security contributions and payments of the most yielding taxes, such as Value-added Tax, as well as Personal and Corporate Income Taxes. While these measures would be ultimately budget-neutral provided that the associated payment were carried out in the second half of 2020([8]), they provided additional liquidity to firms within the year.

The fiscal outlook for 2021 and outer years remains surrounded by high uncertainty. According to the Commission 2020 autumn forecast, the deterioration of the general government budget balance is projected to be temporary, with the deficit decreasing to 4.5% and 3% of GDP in 2021 and 2022, respectively, on the back of the expected economic recovery and the phasing-out of supportive policy measures. This is consistent with the general government debt-to-GDP ratio resuming a declining path in 2021 and reaching 127.2% by 2022. The fiscal outlook remains surrounded by an unusually high degree of uncertainty and risks are overall tilted to the downside, linked to the accumulation of public contingent liabilities stemming from some public corporations and the crisis mitigation measures targeting the private sector. This adds to risks related to pre-pandemic public contingent liabilities, including those linked to past bank support measures.

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

([7]) Public guarantees corresponding to around 70% of the available financial envelope were issued in the year to August 2020.

([8]) Risks surrounding the budgetary impact of these measures are tilted to the downside, linked to possible insolvencies and deterioration in compliance culture.

3.2. POLICY ISSUES

The profile of fiscal support will be a central issue. On 19 September 2020, against the background of the activation of the general escape clause of the Stability and Growth Pact – which is planned to remain active in 2021([9]) – the Commission provided to Portugal some orientations for fiscal policy ahead of the preparation of the State Budget for 2021.([10]) While taking due account of the high prevailing uncertainty, policy measures should strike an appropriate balance between two mutually-enforcing objectives: in the short term, to effectively sustain the economy and support the ensuing recovery and, when economic conditions allow in the medium to long term, to safeguard fiscal sustainability to strengthen economic resilience in view of Portugal's high public debt-to-GDP ratio. The effectiveness of such policy measures would be enhanced by appropriated targeting and regular reviews. At the same time, Portugal can count on substantial EU support from the Next Generation EU package, which will support recovery-focused investment hand-in-hand with the implementation of key growth-enhancing reforms.

The COVID-19 crisis added to pre-existing pressures on current government expenditure. The gradual unfreezing of pay progression in the public sector and retroactive mitigating measures for special careers, combined with the continuous growth of the public workforce (2.2%([11]) y-o-y in the second quarter of 2020) continued to drive up wage expenditure, which increased by 4.1% y-o-y in the year to August 2020 (on a cash basis). Also, recurrent increases to low pensions – above the reference for regular pension indexation – and the sequential broadening of pathways to early retirement, on top of the underlying upward trend driven by demographic ageing, translated into an increase in pension spending by around 3.3% y-o-y in the year to August 2020 (on a cash basis). These public spending pressures were compounded by a pandemic-related rise in unemployment benefit payments, which increased – albeit from a low base – by 20.5% in the year August 2020 (on a cash basis). At the same time, the bottom-up review of public expenditure aimed at improving the efficiency of public spending in some areas – which has been ongoing since 2016 – has progressed slowly and generated so far only modest budgetary savings. According to the State Budget for 2020, the review was expected to generate more limited budgetary savings of EUR 190 million (0.1% of GDP), compared with EUR 236 million in 2019. On balance, the planned efficiency gains risk falling short of offsetting the aforementioned pressures on current public expenditure. During the mission, the authorities expressed their intention to deepen the review in 2021, focusing, among other areas, on health, education, and public procurement.

A stronger budgetary framework would help freeing up resources for the green and digital transitions and getting the most out of Next Generation EU. While the 2015 Budgetary Framework Law (BFL) could strengthen overall planning and expenditure control through a stronger medium-term focus and enhanced transparency, its effective implementation has suffered repeated delays. A working group to evaluate the implementation of the 2015 BFL and identify the possible need for changes presented its conclusions to the government in May 2020. Among others, the working group proposed to: (i) refine wording to reflect more accurately the binding requirements of the Stability and Growth Pact; (ii) introduce some flexibility in multiannual budgetary planning, notably regarding changes to the government expenditure ceilings for the subsequent year; (iii) require that, during the discussion of the Draft State Budget in parliament, proposed amendments be accompanied by a quantification of their budgetary impact; and (iv) take a step-by-step approach to the implementation of "programme budgeting" and accrual accounting.([12]) During the summer of 2020, the parliament adopted on that basis an

([9]) Communication of 20 March 2020 from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact, COM(2020) 123 final.

([10]) Letter of 19 September 2020 from the Commission's Executive Vice-President Valdis Dombrovskis and Commissioner Paolo Gentiloni to Portugal's Minister of State and Finance João Leão.

([11]) These are careers in the public sector where progression depends on the time of service, including, among others, judicial magistrates, military personnel of the Armed Forces and the Republican National Guard, and teachers.

([12]) "Programme budgeting" foresees the preparation of specific budgets for each of the public policies, highlighting the ensuing costs and sources of funding, as well as the envisaged objectives and outcomes.

amendment to the 2015 BFL, which preserved overall the main gist of the original legal basis, but brought about another postponement of its effective implementation.([13]) In particular, while some of the new provisions should start being implemented in the context of the State Budget for 2021 and the long-delayed decree-law establishing the budgetary programmes should come to light during the first half of next year, most changes are now planned for 2023, envisaging full implementation only by 2026. Putting into effect these reforms would contribute to upgrading Portugal's budgetary framework and strengthening expenditure control, cost efficiency, and appropriate budgeting. These will take centre stage in a context of additional EU financial support from Next Generation EU and the need to direct public resources to new strategic priorities, namely delivering the green and digital transitions.

The COVID-19 crisis halted the ongoing reforms to strengthen efficiency in the National Health Service (NHS). The Portuguese NHS has been facing a challenging financial situation for years. On the one hand, its expenditure has been increasing at an average growth rate greater than 4% y-o-y since 2015, driven by spending in human resources, drugs, and medical devices. On the other hand, initial budgets have proven to be insufficient, reflecting weaknesses in planning, costing, and management control. Despite a non-negligible decrease compared with 2018, public hospitals accumulated an average stock of arrears of around EUR 600 million (0.3% of GDP) over 2019. At the same time, Portugal has established a track record of recurrent bailouts by the government, which have not succeeded in avoiding a systematic vicious cycle of hospitals' indebtedness, with knock-on effects on supply-chain relationships. The implementation of a comprehensive plan to improve the sustainability of the health system and tackle the root causes of persistently high arrears got under way in 2019, following up on the recommendations by a temporary task force that has been in the driving seat of the reform since 2018. The plan was expected to introduce a new governance model for NHS hospitals, with substantial increases in hiring autonomy and annual budgets being combined with enhanced joint monitoring by the Ministries of Finance and Health. Meetings with the executive boards of NHS hospitals have been ongoing since 2019 but there are non-negligible implementation risks. In particular, while the term of the above-mentioned task force expired on 30 June 2020 ([14]), the permanent structure that was created in June 2019 to take over the lead for evaluating the management of NHS hospitals may be neither fully operational nor adequately staffed to function independently.

Prompt implementation of previous reform plans could improve the resilience of the NHS in the face of the COVID-19 outbreak. Key milestones are still to be implemented, such as: (i) the setup of management contracts with the hospitals' executive boards to introduce financial incentives and penalties based on performance indicators; and (ii) the prevalent signing of activity and budget plans to spell out hospitals' main lines of strategic and operational action and, importantly, their staff and investment planning. Compared with last year's budget, the initial State Budget for 2020 included an increase of around EUR 1 billion (0.5% of GDP) in the NHS budget, which was later reinforced with additional EUR 300 million to cover for additional spending to help coping with the COVID-19 outbreak. Higher funding combined with a dramatic decrease in hospital procedures not directly related to COVID-19 – in view of the need to channel resources to fight the pandemic and patients' fear of contracting the virus while at hospital – led to a significant improvement of the NHS balance by August 2020, when there was a surplus of 0.1% of GDP. Looking forward, however, the NHS remains particularly vulnerable to a wider spread of the virus, notably in view of the resources needed to deliver the regular health services alongside the care for COVID-19 patients.

The aggregate financial situation of state-owned enterprises (SOEs) ended up surprising on the positive side in 2019, just before the COVID-19 crisis hit. Measures to identify and correct deviations in SOEs from the approved budgets in good time, as well as to improve transparency and reporting standards are being implemented gradually. In 2019, the aggregate net income of SOEs turned positive for the first time in years.

([13]) Law No 41/2020 of 18 August.

([14]) The term of the task force had been extended to 30 June 2020 through the Resolution of the Council of Ministers No 3/2020 of 5 February.

However, net incomes remained chronically negative in a few sectors, making specific SOEs especially vulnerable to the direct consequences of the COVID-19 outbreak. TAP Air Portugal – the country's flag carrier – received the Commission's approval for public rescue aid to a maximum of EUR 1.2 billion (0.6% of GDP), of which the disbursement of EUR 946 million was already included in the Supplementary State Budget for 2020. Similarly, also SATA Air Açores was granted rescue aid for EUR 132.5 million (0.1% of GDP). Following the statistical recording of similar measures in the recent past, both operations will likely be considered by the statistical authorities as capital transfers leading to an increase in both the public deficit and debt. The parliament decided in March 2020 to restore to its former design the legal framework for public-private partnerships (PPPs), which had been relaxed in December 2019. Also, the government took legal steps to prevent private contractors from receiving financial compensation, when contractually due, for losses incurred during the COVID-19 outbreak, for example due to decreased traffic on motorways under PPPs following lock-down restrictions.

4. FINANCIAL SECTOR

4.1. FINANCIAL STABILITY

Caution and uncertainty characterise the impact of the pandemic on the Portuguese financial sector. Banks have generally adjusted to the new operating environment but risks remain, particularly as loan moratoria may lead to a delayed materialisation of credit risk. Time lags in the availability of sectoral data make it more difficult to evaluate how far banks' balance sheets were damaged by the crisis and the first wave of measures to slow the spread of the virus.

The policy measures deployed by the Portuguese authorities and at euro area level have softened the initial impact of the pandemic on the Portuguese financial system. They have primarily helped households and firms to overcome temporary liquidity needs. Likewise, a number of financial sector measures have contributed to minimise adverse feedback loops from the financial system to the real economy (see section 4.2). However, the uncertainty around the materialisation and magnitude of disruptions to the real economy and their subsequent impact on the financial system remains high.

The Portuguese banking system is more resilient now than at the outset of the global financial crisis a decade ago, but there are also new vulnerabilities. The banking system's solvency position is stronger now, banks' reliance on market funding has declined and their cost base has been reduced. At the same time, profitability is lower than before the previous crisis and the level of NPLs is higher. The banking system's Core Equity Tier 1 (CET1) capital ratio stood at 14.6% in Q2-2020. While this is below the European average, it comes after a steady increase in capital ratios, most recently also reflecting the impact of state guarantees, which reduced risk weighted assets and retained earnings (Table 4.1). At the crisis' onset, supervisors relaxed several capital requirements allowing banks to manage their equity in a flexible way during the pandemic. However, banks use this flexibility to different degrees.

Pre-pandemic pressures on profitability will likely be exacerbated, notably reflecting higher impairments. The profitability of the banking system as a whole decreased, following a substantial increase in loan impairments, but return on equity (ROE) for the banking system remained positive (0.3%) in June 2020 (Table 1). Profitability levels remain quite heterogeneous across banks. The positive effect of credit guarantee schemes on intermediation income through higher loan volumes, was offset by falling interest rate on loans, ultimately diminishing the intermediation income when compared to June 2019 data. Competitive pressure has also weighed on the intermediation margin. Revenue positive, the mortgage rates seem to have reached a floor at around 1% in September 2019. Likewise, the attribution of new mortgages, which has grown in tandem with sinking interest rates since 2012 (Graph 4.1), seems to have stabilised at a level that assures banks a growing mortgage stock. On the cost side, while the lockdown has accelerated branch closures, staff reductions have generally come to a halt. Nonetheless, some banks lowered staff cost through reducing variable remuneration

Table 4.1: **Financial stability indicators**

	Q4-2016	Q4-2017	Q4-2018	Q2-2019	Q4-2019	Q1-2020	Q2-2020
Non-performing loans	17.2	13.3	9.4	8.3	6.1	5.9	5.5
o/w NFC sector	29.4	25.2	18.5	16.6	12.3	11.9	11.1
o/w HH sector	8.7	7.1	5.1	4.4	3.7	3.7	3.6
Coverage ratio	45.4	49.9	52.4	52.7	51.7	51.6	53.2
Return on equity(1)	-5.5	-0.8	2.7	5.3	4.3	1.9	0.3
Return on assets(1)	-0.3	0.0	0.3	0.5	0.5	0.2	0.1
Total capital ratio	12.3	15.2	15.2	16.1	16.7	16.7	17.2
CET 1 ratio	11.4	13.9	13.2	13.9	14.1	14.1	14.6
Tier 1 ratio	11.7	14.5	13.9	14.8	15.2	15.3	15.8

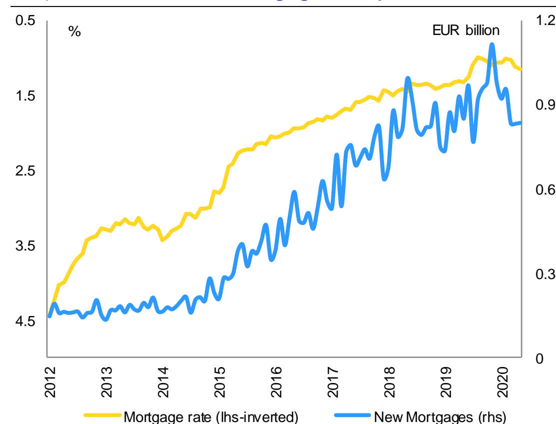
(1) Annualised data

Source: Banco de Portugal and ECB

at the lockdown's onset. The crisis exposed the need to pursue digitalisation further at an even faster pace, which however implies additional costs and operational risks. Going forward, banks' main challenges will be to direct funds to profitable lending opportunities. The economy's bounce back will partly depend on the financial sector's central role to channel funds to the most efficient actors.

The non-performing loan (NPL) ratio of Portuguese banks remained high and the downward trend witnessed in recent years is bound to reverse as a result of the pandemic. While asset quality has continuously improved in recent years, with the NPL-ratio dropping to 5.9% in Q1-2020, down from 8.9% a year earlier, it is still twice the European average (2.9%). These NPLs were concentrated in the corporate segment and their distribution across banks was uneven. The decline in the NPL ratio has mainly been driven by write-offs and sales, which have come close to a complete halt since the start of the pandemic.

Graph 4.1: **Ever lower mortgage rates pull demand**



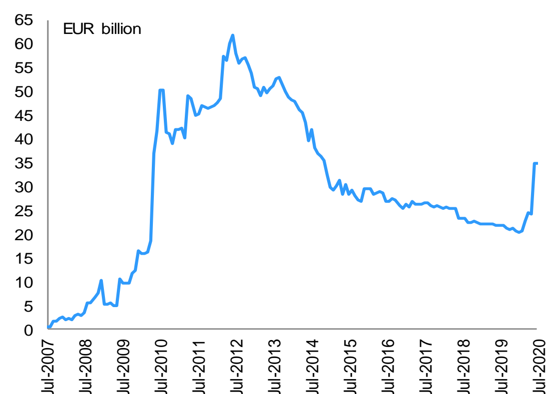
Source: Banco de Portugal

Banks face risks of deterioration in asset quality as NPLs are likely to pick up once the loan moratoria expire. The public and private loan moratoria set up in Portugal have helped to address households' and firms' liquidity shortages. Consequently, defaults have not risen yet. In June 2020, about 17% of outstanding household loans and 30% of corporate credit benefited from loan deferrals, mainly concentrated in micro- and small and medium enterprises.[15] As the moratoria blur the line between temporary lockdown-induced liquidity problems and insolvency, the magnitude of possible inflows of NPLs will only become clear once the moratoria expire. To adequately manage this risk, it is important that banks "see through" the temporary payment deferrals and prepare for an increase in defaults by engaging early with borrowers and increasing their loan-loss-provisioning. In this context, the role of authorities is paramount in ensuring a gradual exit from the moratoria and other measures.

Banks' liquidity position strengthened in mid-2020 as deposits outgrew loans. The lockdown put an end to a trend of falling corporate loans that started in November 2010. They increased by EUR 4.5 billion between end February to June 2020 to reach EUR 71.8 billion as redemptions decreased due to moratoria on the one hand, and state-guaranteed loans were made to help firms bridge liquidity gaps, on the other. However, corporate deposits jumped by 19% in June (y-o-y). This reflects an increase in precautionary savings by some firms, as well as social security and tax deferrals. New consumer credit attribution in Q2-2020 fell by over a quarter compared to a year earlier. New mortgage increased by only 0.6% (y-o-y) in Q2-2020. Akin to corporates, with an absolute increase of EUR 9 billion, household deposits have increased more than household loans.

([15]) 16% of micro-companies and 5% of small companies have at least one loan contract under a moratorium, against less than 1% for medium and large enterprises.

Graph 4.2: **ECB borrowing rose EUR 10 billion in Q2-2020**



*Banks located in Portugal
Source: Banco de Portugal

The ECB's monetary policy easing, including the June 2020 targeted longer term refinancing operations (TLTRO), has supported the liquidity position of banks. In June, banks increased their ECB borrowing by EUR 10 billion (Graph 2) to a total of EUR 35 billion. Banks have not issued any bonds to meet the minimum requirement for own funds and eligible liabilities (MREL) since November 2019. Banks are hesitant to tap capital markets, given their excess liquidity, which has a cost, and given that MREL targets for 2020 remain indicative. However, banks are required to build up MREL incrementally. Significant institutions must reach binding intermediate targets in January 2022 and final targets in January 2024. The overall MREL gap of significant institutions still amounts to approximately EUR 8.2 billion.

4.2. POLICY ISSUES

Authorities have put in place an array of measures to help banks ensure the flow of credit to the economy and expand their loss-absorbing capacity. Given the urgency and the size of the challenge presented by the economic fallout, a plethora of measures and policies has been developed, updated and fine-tuned in a very short timeframe by both national and European authorities. The financial system plays a critical role in preventing temporary cash flow difficulties for both firms and households. Therefore, the primary objective behind the design of financial sector policies was to provide credit institutions with the appropriate incentives to continue carrying out their role as financial intermediaries in the economy. The ECB has provided additional liquidity to the euro area banking system and relaxed collateral conditions as of mid-March 2020. Measures put in place by the Portuguese government and Banco de Portugal were in turn focused on the one hand on providing firms and households with targeted immediate liquidity (through direct liquidity injections, guarantees to viable firms and grants channelled through the banking system) and, on the other hand, on prudential and supervisory actions. The latter notably concern the supervisory treatment of loans under moratoria (the original bill on moratoria allows eligible borrowers not to pay interest and principal until March 2021[16]), but also the flexibility in complying with capital and liquidity requirements. Overall, in a coordinated manner, micro- and macro-prudential policies are promoting the use of accumulated capital buffers, thereby reducing the risk of a credit crunch. A constant monitoring of the materialisation of risks will be required as the COVID-19 crisis continues.

Macro-prudential measures implemented in 2018 are gradually strengthening borrowers' resilience and reducing the share of risky mortgage loans. These measures ensured that both households and banks entered the pandemic in a less vulnerable position, as new loans were generally less risky. For example, mortgages with a loan-to-value ratio above 90%, still accounting for 22% of new mortgages in July 2018, have almost disappeared. In response to the pandemic, some personal credits were exempted from the applicable debt service-to-income ratio (DSTI) limits, to help households cope with liquidity pressures. In the category of "other systemically important institutions", Banco de Portugal decided to postpone by one year the phase-in of the capital buffer for six banks. This is akin to a capital relief and should help the banking system maintain its exposure to the real economy.

The pandemic has led to a drastic drop in the cash flow generated by local firms and

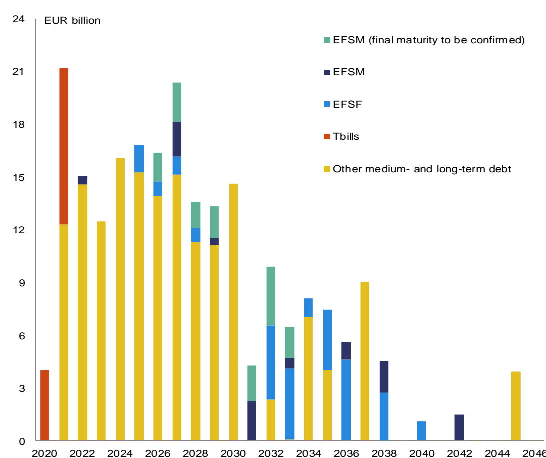
[16] Following an extension of the public moratoria by the Portuguese government, thereafter and until September 2021, only the most affected borrowers - households and firms belonging to the most severely affected sectors - can defer interest, while the remaining enterprises may only defer principal.

consequently to a threat of insolvencies. While this threat has been cushioned by the policy measures, insolvencies could accelerate further with the gradual withdrawal of measures. While Portugal's insolvency practice evolved over the past years to favour firms’ restructuring instead of straight liquidation, it became evident that local businesses faced with the current unprecedented challenges need more tools to stay afloat. To reduce the risk of premature insolvencies in the lockdown context, companies are currently not obliged to file for insolvency within a 30-day deadline. Deadlines were also extended for concluding negotiations initiated under the umbrella of recovery (PER) or payment (PEAP) agreements. Over the summer, the Government approved a draft law, which is pending in Parliament, to establish an extraordinary procedure (Processo Extraordinário de Viabilização de Empresa (PEVE)) to enable companies to respond more efficiently to the pandemic. PEVE is addressed exclusively to firms that are in a difficult or insolvent economic situation due to COVID-19. It aims for a simple, fast-track court ratification of out-of-court restructuring agreements between the company and its creditors. The PEVE is expected to remain in place until the end of 2021. A new inflow of insolvencies would exacerbate the existing challenges faced by the Portuguese judicial system (lengthy judicial proceedings and the still large backlog of cases), which need to be addressed. This is especially important in the current context where courts and judiciary processes will play a paramount role in mitigating the effects of the economic crisis on the Portuguese corporate sector.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Portugal's debt management strategy has mitigated vulnerabilities. The authorities have deployed continuous efforts to reduce overall annual interest expenditure and cap upcoming annual peaks in the debt redemption profile (see Graph 5.1). Financial assistance loans were fully repaid to the IMF by December 2018. Portugal also repaid EUR 2 billion in October 2019 in financial assistance loans to the European Financial Stability Facility (EFSF) that were only due in 2025, without relevant changes to its funding programme. The average residual maturity of Portugal's debt has remained broadly stable at around 8 years. At the outset of the COVID-19 crisis, Portugal had managed to diversify its investor base for sovereign debt, thereby regaining some traditional investors, such as banks.

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



(1) Last update: 18-09-2020

Source: IGCP

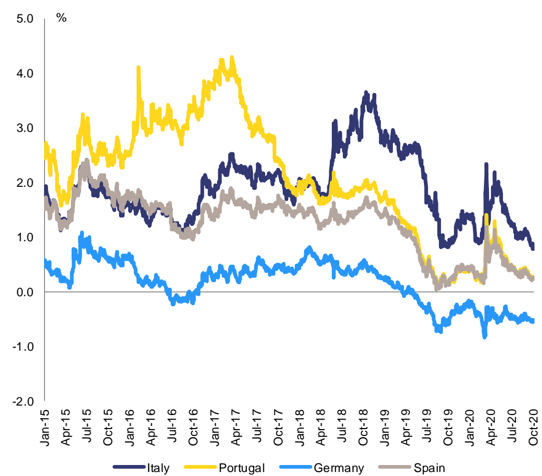
Portugal's financing needs are expected to surge due to the COVID-19 crisis, following steady decreases for a number of years. In 2019, Portugal's financing needs decreased by EUR 1.1 billion (0.5% of GDP), to EUR 19.2 billion. This decline reflected the lower debt redemptions last year (already including the aforementioned early partial repayment of financial assistance loans to the EFSF), which were however partly offset by the higher net acquisition of financial assets (due to capital injections and debt assumptions pertaining to SOEs). However, COVID-19 is projected to halt this trend, with financing needs in 2020 increasing by EUR 10.3 billion (5.2% of GDP) and to reach EUR 29.5 billion. These are planned to be mainly financed through additional issuances of government bonds. At the same time, the cash buffer is planned to be reinforced significantly in 2020 to around 5.6% of GDP, so as to make allowance for higher financing needs also in 2021, coupled with a concentration of debt redemptions in the first half of the latter year. While the government funding plan for 2021 was not available yet at the cut-off date of this report, it is expected to reflect still-elevated financing needs, while envisaging a reduction of the cash buffer towards the end of the year. On 25 September 2020, and following the Commission's proposal of 25 August, the Council approved a loan available to Portugal to a maximum of EUR 5.9 billion (3% of GDP) under the newly available Support to mitigate Unemployment Risks in an Emergency (SURE). The SURE loan to Portugal is expected to ease the country's heightened financing needs in 2020 and 2021 in view of the sudden and severe increase in public expenditure on short-time work schemes and similar measures, as well as health-related measures related to the COVID-19 outbreak.

Portugal's high public debt-to-GDP ratio is expected to be sustainable over the medium term, but remains vulnerable to economic shocks. According to the Commission's forecast for the medium term covering the period 2020-2031, under the no-policy-change assumption, the public debt-to-GDP ratio would still substantially decline over the projection horizon, reaching slightly less than 110% in 2031, supported by a gradual fiscal policy adjustment and by a favourable differential between interest rates and nominal GDP growth (see Annex 1). That notwithstanding, Portugal's debt-to-GDP ratio would remain significantly above the Treaty reference value of 60%. Risks to the pace of public debt reduction are somewhat tilted to the downside given the accumulation of public contingent liabilities – on top of non-negligible pre-existing levels – stemming from some public corporations and the private sector, including through the possible calling of public guarantees.

Portugal's market financing conditions remained favourable until the cut-off date of

this report. Since October 2018, Portugal's sovereign debt rating had an "investment" grade by all four relevant rating agencies. Recently, on 18 September 2020, DBRS confirmed Portugal's rating at BBB-high, with a "stable" outlook. Just before, on 11 September 2020, Standard & Poor's had also confirmed Portugal's rating at BBB, with a "stable" outlook. The accommodative monetary stance in the euro area – especially as a result of the measures taken by the ECB from mid-March onwards – has helped to contain the yields on government bonds and their ensuing volatility, thereby contributing to the effective transmission of monetary policy. Overall, the implicit interest rate on Portugal's public debt decreased steadily since its latest peak at slightly above 4% in 2011, to 2.5% in 2019 and, despite the COVID-19 crisis, it is expected to continue declining in 2020. Moreover, the yields on Portuguese 10-year government bonds were on a declining path between mid-March 2017 and mid-August 2019, when they reached historically low levels of around 0.1% (Graph 5.2). Subsequently, they increased moderately towards the end of 2019, reaching 0.5% in mid-January 2020, and declined back to 0.3% by end-February 2020. Following a period of heightened volatility that coincided with the sudden outbreak of the COVID-19 pandemic, the yields on Portugal's 10-year government bonds had returned to pre-crisis levels at the cut-off date of this report. Overall, the gradually declining spreads confirmed the convergence of Portuguese yields with those of its European peers.

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



Source: European Commission

Sovereign financing and the capacity to repay remain sound but require close monitoring in a context of unprecedentedly high uncertainty. Due to Portugal's high public debt-to-GDP ratio and the latest surge in financing needs triggered by the COVID-19 crisis, yields and the absorption capacity of financial markets remain nevertheless vulnerable, thus requiring regular monitoring. In the short term, Portugal's capacity to repay is set to remain sound, with stable and low yields, as well as a solid cash buffer, even after taking into account the sudden increase in financing needs. In the long term, progress with growth-friendly fiscal consolidation and fiscal-structural reforms would nonetheless be important to strengthen Portugal's fiscal sustainability and the country's capacity to repay.

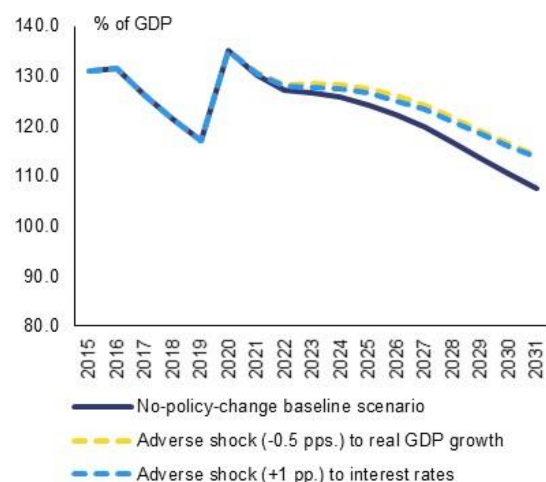
ANNEX 1
European Commission debt sustainability analysis

The present Debt Sustainability Analysis (DSA) uses the Commission 2020 autumn forecast as a starting point to ensure cross-country consistency and to allow factoring in second-round macroeconomic effects. It covers the period 2020-2031 and includes a few technical assumptions for the medium term. [17] While Portugal's general government debt-to-GDP ratio is projected to experience a spike in 2020 in view of the COVID-19 crisis, it is expected to remain on a steady downward path over the medium term. While there are important mitigating factors notably linked to the debt profile, the Commission's DSA confirms that Portugal's debt-to-GDP ratio is particularly sensitive to any worsening of the country's economic and financing conditions.

According to the Commission 2020 autumn forecast, the general government debt-to-GDP ratio is projected to spike at 135.1% in 2020, reflecting the sudden primary deficit and the unfavourable denominator effect arising from the expected contraction of real GDP. It is forecast to resume its decreasing path in 2021, when it is set to drop to 130.3%, helped by the expected rebound in real GDP growth, the gradual phasing-out of fiscal policy support and the pre-financing of grants under the Recovery and Resilience Facility – which in the case of Portugal is expected to amount to around 0.7% of GDP. According to the Commission's no-policy-change baseline scenario, from the projected 127.2% for 2022, the debt-to-GDP ratio is expected to decline to slightly less than 110% of GDP by 2031. Importantly, only in 2028 would the debt-to-GDP ratio be lower than the pre-pandemic level observed in 2019. Despite the expected decline, the debt-to-GDP is set to remain significantly above the Treaty reference value of 60% over the medium term.

The projected gradual decrease in Portugal's general government debt-to-GDP ratio crucially hinges on continuous primary surpluses and favourable nominal growth-interest rate differentials in the projection's outer years. In plausible scenarios alternative to the Commission's no-policy-change baseline scenario based on the 2020 autumn forecast – incorporating potential shortfalls in real GDP growth or interest rate hikes – the debt-to-GDP ratio would still be forecast to be on a steady downward path. The pace of debt reduction would nevertheless be significantly impaired (see Graph A1.1). For instance, lower real GDP growth by 0.5 pps. or higher interest rates by 1 pp. would lead to debt-to-GDP ratios of close to 115% by 2031.

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



Source: European Commission (based on 2020 autumn forecast)

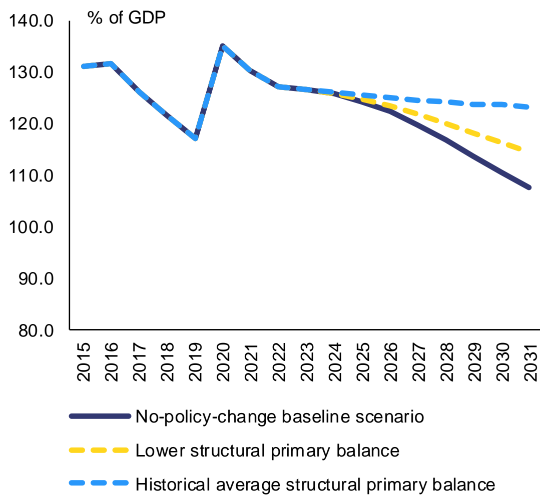
On 20 July 2020, the Council recommended Portugal to pursue, when economic conditions allow, fiscal policies aimed at achieving prudent medium-term fiscal positions and ensuring debt sustainability, while enhancing investment. [18] A growth-friendly fiscal consolidation strategy for the medium term remains instrumental to safeguard Portugal's fiscal sustainability. Were Portugal's structural primary balance to be reduced by half compared with the Commission's no-policy-change scenario, the general government debt-to-GDP ratio would be at close to 115% by 2031 (see Graph A1.2). Likewise, were Portugal's structural primary balance to converge by 2026 to its last 15-year historical average (computed over

[17] In particular, a progressive unwinding of the extraordinary negative impact of the COVID-19 crisis on public finances is assumed – meaning that the structural primary balance is set to progressively adjust over the projection period, converging back to its pre-crisis forecasted level (i.e. the level projected for 2021 in the Commission 2019 autumn forecast).

[18] Council Recommendation of 20 July 2020 on the National Reform Programme of Portugal and delivering a Council opinion on the 2020 Stability Programme of Portugal, OJ C 282, 26.8.2020, p. 142 – 148.

the period 2005-2019), the public debt-to-GDP ratio would be at more than 120% by 2031, as much as 16 pps. above the Commission's no-policy-change baseline scenario.

Graph A1.2: **Public debt projections under different scenarios for fiscal consolidation**



Source: European Commission (based on 2020 autumn forecast)

ANNEX 2

European Commission macroeconomic and fiscal projections

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

Annual % change	2019	2020	2021	2022
1. Private consumption expenditure	2.4	-7.9	4.9	3.5
2. Government consumption expenditure	0.7	1.0	1.6	0.8
3. Gross fixed capital formation	5.4	-10.2	6.3	5.2
4. Final domestic demand	**2.7**	**-6.8**	**4.5**	**3.3**
5. Change in inventories	--	--	--	--
6. Domestic demand	**2.7**	**-6.9**	**4.6**	**3.3**
7. Exports of goods and services	3.5	-21.0	9.7	5.4
7a. - of which goods	2.9	-12.5	8.6	3.9
7b. - of which services	4.7	-35.2	12.1	8.6
8. Final demand	**3.0**	**-11.2**	**6.0**	**3.9**
9. Imports of goods and services	4.7	-15.6	7.5	5.0
9a. - of which goods	3.8	-13.6	7.2	4.4
9b. - of which services	8.6	-24.0	8.9	7.5
10. Gross domestic product at market prices	**2.2**	**-9.3**	**5.4**	**3.5**
Contribution to change in GDP				
11. Final domestic demand	2.6	-6.7	4.6	3.3
12. Change in inventories + net acq. of valuables	0.1	-0.2	0.1	0.0
13. External balance of goods and services	-0.5	-2.4	0.7	0.1

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

Annual % change	2019	2020	2021	2022
1. Private consumption expenditure	3.3	-7.0	6.4	5.2
2. Government consumption expenditure	3.4	6.1	1.4	1.2
3. Gross fixed capital formation	8.0	-9.5	7.9	6.9
4. Final domestic demand	**4.2**	**-5.2**	**5.7**	**4.8**
5. Change in inventories	--	--	--	--
6. Domestic demand	**4.2**	**-5.5**	**5.9**	**4.7**
7. Exports of goods and services	4.1	-21.6	10.2	6.6
8. Final demand	**4.2**	**-10.4**	**7.1**	**5.2**
9. Imports of goods and services	4.7	-17.4	8.1	6.2
10. Gross national income at market prices	4.1	-6.9	6.5	4.9
11. Gross value added at basic prices	3.9	-6.8	6.9	4.7
12. Gross domestic product at market prices	**4.0**	**-7.3**	**6.7**	**4.9**
Nominal GDP, EUR bn	213.3	197.7	211.0	221.3

Table 3: Implicit price deflators

% change in implicit price deflator	2019	2020	2021	2022
1. Private consumption expenditure	0.9	0.9	1.4	1.6
2. Government consumption expenditure	2.6	5.0	-0.2	0.4
3. Gross fixed capital formation	2.5	0.8	1.5	1.6
4. Domestic demand (incl. inventories)	**1.5**	**1.5**	**1.3**	**1.4**
5. Exports of goods and services	0.5	-0.7	0.5	1.1
6. Final demand	**1.2**	**0.9**	**1.1**	**1.3**
7. Imports of goods and services	0.0	-2.2	0.5	1.2
8. Gross domestic product at market prices	**1.7**	**2.2**	**1.3**	**1.4**
HICP	**0.3**	**-0.1**	**0.9**	**1.2**

Table 4: Labour market and cost

Annual % change	2019	2020	2021	2022
1. Labour productivity (real GDP per employee)	1.4	-5.7	3.2	1.7
2. Compensation of employees per head	3.5	0.6	2.3	1.8
3. Unit labour costs	**2.2**	**6.1**	**-1.1**	**0.2**
4. Total population	0.0	0.0	0.0	0.0
5. Population of working age (15-74 years)	0.0	0.0	0.0	0.0
6. Total employment (fulltime equivalent)	0.8	-3.8	2.1	1.7
7. Calculated unemployment rate - Eurostat definition (%)	**6.4**	**7.9**	**7.6**	**6.5**

Table 5: External balance

levels, EUR bn	2019	2020	2021	2022
1. Exports of goods (fob)	57.9	50.4	55.1	57.9
2. Imports of goods (fob)	74.7	62.9	67.9	71.7
3. Trade balance (goods, fob/fob) (1-2)	**-16.8**	**-12.5**	**-12.8**	**-13.8**
3a. p.m. (3) as % of GDP	**-7.9**	**-6.3**	**-6.1**	**-6.2**
4. Exports of services	34.9	22.4	25.2	27.6
5. Imports of services	17.6	13.3	14.5	15.7
6. Services balance (4-5)	**17.3**	**9.1**	**10.7**	**11.9**
6a. p.m. 6 as % of GDP	**8.1**	**4.6**	**5.1**	**5.4**
7. External balance of goods & services (3+6)	**0.5**	**-3.4**	**-2.1**	**-2.0**
7a. p.m. 7 as % of GDP	**0.2**	**-1.7**	**-1.0**	**-0.9**
8. Balance of primary incomes and current transfers	-0.2	1.7	1.1	0.9
8a. - of which, balance of primary income	-4.9	-3.8	-4.5	-4.7
8b. - of which, net current Transfers	4.8	5.5	5.6	5.6
8c. p.m. 8 as % of GDP	-0.1	0.8	0.5	0.4
9. Current external balance (7+8)	**0.3**	**-1.7**	**-1.0**	**-1.1**
9a. p.m. 9 as % of GDP	**0.2**	**-0.9**	**-0.5**	**-0.5**
10. Net capital transactions	1.7	2.1	2.3	2.2
11. Net lending (+)/ net borrowing (-) (9+10)	**2.0**	**0.3**	**1.2**	**1.1**
11a. p.m. 11 as % of GDP	**1.0**	**0.2**	**0.6**	**0.5**

Table 6: Fiscal accounts

	2019	2020	2021	2022
% of GDP				
Taxes on production and imports	15.0	14.6	14.4	14.5
Current taxes on income, wealth, etc.	9.8	9.3	9.2	9.4
Social contributions	11.8	12.5	12.2	12.1
Sales and other current revenue	5.8	5.9	6.1	6.0
Total current revenue	**42.4**	**42.2**	**41.9**	**42.0**
Capital transfers received	0.3	0.5	1.0	0.5
Total revenue	**42.7**	**42.8**	**43.0**	**42.5**
Compensation of employees	10.7	12.1	11.7	11.5
Intermediate consumption	5.2	6.0	5.5	5.2
Social transfers in kind via market producers	1.9	2.1	1.9	1.9
Social transfers other than in kind	16.3	18.5	17.8	17.4
Interest paid	3.0	2.9	2.6	2.5
Subsidies	0.4	1.6	1.0	0.4
Other current expenditure	2.2	2.7	2.6	2.6
Total current expenditure	**39.7**	**45.8**	**43.2**	**41.5**
Gross fixed capital formation	1.9	2.5	2.9	3.0
Other capital expenditure	1.0	1.8	1.3	1.0
Other (residual)	3.3	4.4	3.9	3.6
Total expenditure	**42.7**	**50.0**	**47.4**	**45.5**
General government balance (ESA2010)	**0.1**	**-7.3**	**-4.5**	**-3.0**
Primary balance	3.1	-4.4	-1.8	-0.5
% change				
Taxes on production and imports	3.6	-10.2	5.8	5.1
Current taxes on income, wealth, etc.	0.8	-12.1	6.5	7.0
Social contributions	5.9	-2.1	3.7	4.2
Sales and other current revenue	13.9	-9.5	24.1	8.5
Total current revenue	**4.0**	**-7.7**	**6.0**	**5.1**
Capital transfers received	-30.9	53.2	109.2	-51.0
Total revenue	**3.6**	**-7.3**	**7.2**	**3.8**
Compensation of employees	4.0	4.6	3.5	2.9
Intermediate consumption	2.8	5.7	-1.3	-0.7
Social transfers in kind via market producers	5.0	1.7	1.2	1.2
Social transfers other than in kind	3.9	5.3	2.4	2.5
Interest paid	-8.3	-8.4	-4.3	0.0
Subsidies	6.7	261.4	-28.4	-55.9
Other current expenditure	2.1	11.3	3.3	3.3
Total current expenditure	2.7	6.9	0.7	0.6
Gross fixed capital formation	5.9	22.4	23.0	9.2
Other capital expenditure	-8.8	55.3	-18.4	-19.9
Total expenditure	**2.5**	**8.8**	**1.2**	**0.6**
Nominal GDP, EUR bn	**213.3**	**197.7**	**211.0**	**221.3**

Table 7: Government debt developments

	2019	2020	2021	2022
ESA2010 budget balance (% of GDP)	**0.1**	**-7.3**	**-4.5**	**-3.0**
ESA2010 gross debt (% of GDP)	117.2	135.1	130.3	127.2
ESA2010 budget balance	**0.2**	**-14.4**	**-9.4**	**-6.6**
Gross debt	250.0	267.2	274.8	281.4
Change in gross debt	0.8	17.3	7.6	6.6
Nominal GDP	213.3	197.7	211.0	221.3
Real GDP growth (% change)	**2.2**	**-9.3**	**5.4**	**3.5**
Change in gross debt (% of GDP)	0.4	8.7	3.6	3.0
Stock-flow adjustments (% of GDP)	0.4	1.4	-0.9	0.0
Gross debt ratio	**117.2**	**135.1**	**130.3**	**127.2**
Change in gross debt ratio	0.4	17.9	-4.9	-3.1
Primary balance	3.1	-4.4	-1.8	-0.5
"Snow-ball" effect	-1.6	11.9	-5.8	-3.5
of which				
Interest expenditure	*3.0*	*2.9*	*2.6*	*2.5*
Real growth effect	*-2.6*	*11.7*	*-6.8*	*-4.3*
Inflation effect	*-2.0*	*-2.8*	*-1.6*	*-1.7*
Stock-flow adjustments	**0.4**	**1.4**	**-0.9**	**0.0**
Implicit interest rate	*2.5*	*2.3*	*2.1*	*2.0*

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