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Post-Programme Surveillance Report

Portugal, Spring 2024

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Spring 2024

EUROPEAN ECONOMY

Institutional Paper 292

ABBREVIATIONS

BFL	Budgetary Framework Law
CA	Current account
CET1	Common equity tier 1
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
IGCP	Portuguese Treasury and Debt Management Agency
IMF	International Monetary Fund
INE	Portugal's National Statistical Office
MREL	Minimum requirement for own funds and eligible liabilities
LCR	Liquidity coverage ratio
NFCs	Non-financial corporations
NHS	National Health Service
NIIP	Net international investment position
NPLs	Non-performing loans
PPS	Post-programme surveillance
q-o-q	Quarter-on-quarter
RoE	Return on equity
RoA	Return on assets
RRF	Recovery and Resilience Facility
RRP	Recovery and resilience plan
SMEs	Small- and medium-sized enterprises
SOEs	State-owned enterprises
VAT	Value-added Tax
y-o-y	Year-on-year

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EXECUTIVE SUMMARY

The 19th post-programme surveillance (PPS) mission to Portugal took place from 28 February to 1 March 2024. This mission involved European Commission staff in liaison with European Central Bank (ECB) staff. European Stability Mechanism (ESM) staff participated on aspects relating to the ESM's Early Warning System.

Portugal's economic growth slowed from 6.8% in 2022 to 2.3% in 2023. In quarterly terms, the slowdown took place in the second and third quarters of 2023, followed by a rebound in the final quarter of the year when both private consumption and investments increased substantially, helped by the stabilisation in interest rates. **In full-year terms, GDP growth is projected to slow down further in 2024 and to pick up again in 2025, outperforming the euro area average.** The labour market remained robust as both labour supply and employment continued growing at high rates amid a broadly stable unemployment rate. Inflation slowed from 8.1% in 2022 to 5.3% in 2023 and 2.5% (y-o-y) in the first quarter of 2024 and is set to further recede over the forecast horizon. The overall balance of risks to the economic performance remains on the downside, reflecting significant geopolitical risks and uncertainty.

Portugal's general government balance reached a surplus of 1.2% of GDP in 2023. After a deficit of 0.3% of GDP in 2022, Portugal's general government balance improved markedly to a surplus of 1.2% of GDP in 2023. Over the forecast horizon, the surplus is forecast to decrease to 0.4% of GDP in 2024, and to remain broadly unchanged in 2025. These developments are mainly driven by the fiscal measures introduced with the 2024 State Budget, the projected economic slowdown, and the moderation in inflation. The public debt-to-GDP ratio is set to steadily decline, albeit at a slower pace. It reached a 99.1% in 2023, and it is forecast at 95.6% in 2024 and 91.5% in 2025. Risks to the fiscal outlook are on the downside. Other than those related to general macroeconomic risks, specific risks to the country's public finances include ongoing requests for a financial rebalancing of public-private partnerships (PPPs) related to the impact of COVID-19. Portugal is implementing measures addressing the quality and sustainability of its public finances, with key fiscal-structural reforms yet to be implemented embedded in the country's recovery and resilience plan.

Portugal's banks performed strongly in 2023. Banks' profitability increased to the highest level over the past two decades as returns on both assets and equity surged in 2023, helped by higher interest rate spreads. The large share of loans on variable rates in Portugal allowed banks to perform even better than most EU peers. Nevertheless, risks to the financial sector remain in light of the uncertain external environment, possibly leading to risk premia increases in the international financial markets and additional pressure on vulnerable borrowers. Rising prices of residential real estates in Portugal also warrant close monitoring although several factors, such as supply bottlenecks and strong non-residents ownership and participation in the market, will continue playing a supportive role, resulting in low risks of abrupt price corrections.

Portugal retains the capacity to service its debt. Despite a number of challenges, its economic, fiscal and financial situation is sound overall. According to the Commission's debt sustainability analysis, medium-term risks to Portugal's fiscal sustainability are high overall, but low in the short- and long-term. Financing needs decreased in 2023 and are expected to remain broadly stable in 2024. An EFSM repayment was executed in November 2023. The next repayments to the EFSF and the EFSM are scheduled for 2025 and 2026, respectively. Financial market perceptions of Portugal's sovereign debt remain favourable. The four main rating agencies have upgraded the country's sovereign debt rating or outlook in 2023 and in 2024 until the cut-off date of this report.

1. INTRODUCTION

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the nineteenth post-programme surveillance (PPS) mission to Portugal from 28 February to 1 March 2024. Staff from the European Stability Mechanism (ESM) participated in the meetings on aspects related to the ESM's Early Warning System. IMF staff also participated in the meetings. Under PPS, the Commission carries out regular review missions to euro area Member States that have had a financial assistance programme. The objective of the PPS missions is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt. ([1])

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

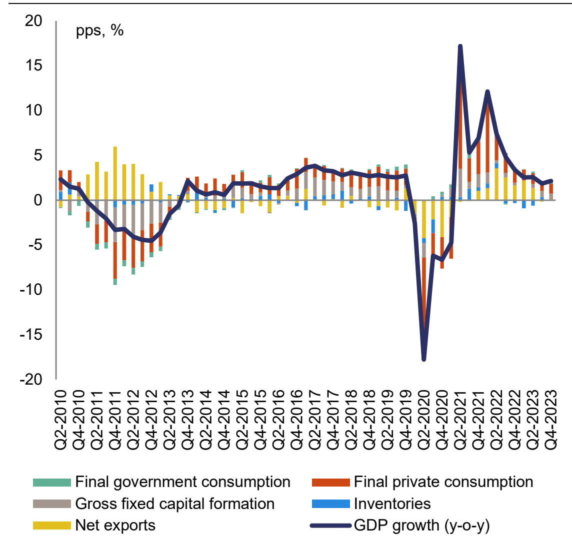
This report reflects information available and policy developments that have taken place until 30 April 2024. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2024 spring forecast released on 15 May 2024 (with cut-off date 30 April 2024).

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

2. ECONOMIC DEVELOPMENTS

Portugal's GDP growth slowed in 2023, from 6.8% in 2022 to 2.3% in 2023 reflecting a broad-based deceleration across GDP components. The main slowdown took place in the second and third quarters of 2023, followed by a rebound in the final quarter of the year. Both private consumption and investments increased substantially in the final quarter of the year, helped by the stabilisation in interest rates. In addition, the end of the cycle for the use of Cohesion Funds for the 2014-2020 period appears to have had a significant one-off impact on fixed capital investments, which surged by 3.3% (q-o-q) in the final quarter of the year. The purchase of military aircraft provided another one-off support to investments. Net exports contributed positively to GDP growth for the year as a whole mainly due to the strong performance of tourism. However, imports started outpacing exports in the second half of the year, in line with the rebound in domestic demand.

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



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

Monthly indicators appear broadly favourable in early 2024. The economic sentiment indicator based on the European Commission's business and consumer surveys picked up in the first quarter of 2024, moving slightly above the long-term average in February and March. Industrial output, construction and services were also improving early in the year. Tourism statistics weakened substantially in annualised terms in January but re-accelerated again in February and March. However, the interpretation of the high-frequency indicators and their impact on GDP is complicated by various technical factors, including the change of the base year for some of the indicators and calendar adjustments linked to the leap-year effect and the Easter holidays at the end of March. In addition, investment statistics were likely affected by the afore-mentioned cycle of Cohesion Funds.

In full-year terms, GDP growth is projected to slow down further in 2024 and to pick up again in 2025. Taking into account the flash GDP estimate of 0.7% (q-o-q) for the first quarter of 2024, full-year GDP growth is projected at 1.7% in 2024 and 1.9% in 2025, supported by private consumption and investment as well as some improvement in demand from the main trading partners. In both years, investment is projected to benefit substantially from the implementation of the Recovery and Resilience Plan (RRP) and other EU-funded projects. Consequently, investment growth is forecast to pick up from 2.5% in 2023 to 3.9% in 2024 and 3.7% in 2025.

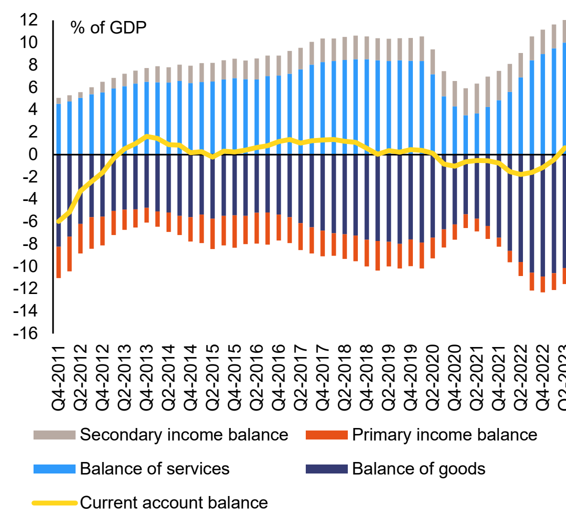
The balance of risks to Portugal's growth outlook remains on the downside. This reflects significant uncertainty on the external environment, including the high volatility in commodity prices. Country-specific risks are mainly linked to the high share of variable interest rate loans for housing and their potential impact on households' consumption. However, this risk has subsided somewhat as the government measures implemented in 2023 have facilitated debt renegotiations and the share of new variable rate loans has declined while the implicit interest rate on mortgages has stabilised (see Section 4 on financial sector developments).

The current account returned to surplus in 2023, following a three-year period of deficits. The current account balance posted a surplus of 1.4% of GDP in 2023. This followed a three-year period of deficits, triggered by the shock on the tourism sector driven by the COVID-19 pandemic in 2020-2021 and the steep rise in energy prices in 2022 driven by Russia's invasion of Ukraine. The sharp improvement in 2023 was supported by favourable developments in energy prices and tourism as well as structural improvements. These related to the continuous increase in the share of renewables, leading to lower demand for energy

imports, and a substantial increase in the share of US and Canadian tourists, who are estimated to have above-average travel budgets.

The current account surplus is projected to moderate amid greater imports of investment goods. In 2024-2025, the projected increase in investments is set to raise demand for imports of investment goods, resulting in a larger deficit in the trade of goods. Tourism is expected to continue improving though at a somewhat slower pace, reflecting some moderation in both volume and price terms. All in all, the current account is projected to remain on positive territory although the surplus is set to contract.

Graph 2.2: **Current account balance**

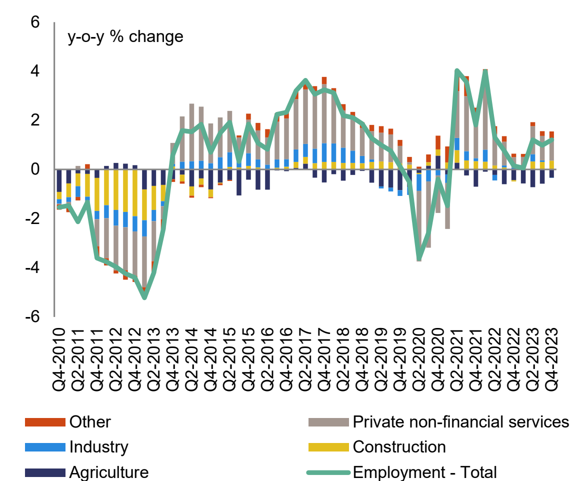


Source: Banco de Portugal.

Portugal's net international investment position (NIIP) improved markedly in 2023. Benefiting from the current-account surplus and large net transfers in the capital account, the NIIP share in GDP improved from -83.6% at the end of 2022 to -72.5% as of end-2023, following substantial improvements in previous years. The NIIP ratio also benefited from the strong rise in nominal GDP and positive valuation effects. The NIIP structure also improved, as the share of non-defaultable instruments accounted for more than 70% of the overall value of net liabilities.

Employment keeps growing at a strong pace. Employment rose by 2.0% in 2023, slowing only marginally from 2.2% in 2022, according to data from the labour force surveys. The largest job gains were recorded in tourism and construction while employment in manufacturing declined. Labour supply increased even faster than employment, helped by strong migration flows, and unemployment edged up consequently from 6.2% in 2022 to 6.5% in 2023. At the beginning of 2024, both the labour force and employment continued expanding at a strong pace and unemployment reached 6.7% in February, marking a small increase from the annual average in 2023 but sliding below the corresponding rate from a year earlier. The labour force survey shows that migration flows have accelerated as the working-age population (16 to 74 years) is estimated to have risen by 1.4% (y-o-y) in February 2024.

Graph 2.3: **Employment evolution by sectors**



Source: Eurostat

Unemployment is expected to fluctuate in narrow margins. Despite the strong start to 2024, employment growth is projected to moderate in the course of the year in line with the projected moderation in tourism. Considering the positive impact of migration, labour supply is expected to move broadly in line with employment, keeping the unemployment rate relatively stable. As some sectors of the economy continue to experience tight hiring conditions, wages are set to grow somewhat faster than inflation, supported also by the sound profit margins in the corporate sector.

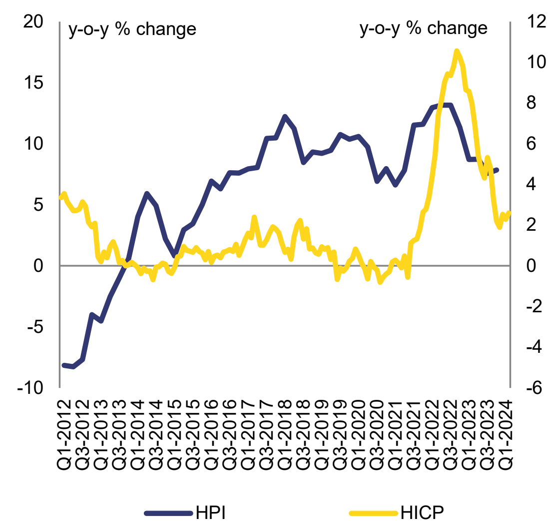
Inflation moved closer to the 2% target in early 2024. Inflation (HICP) receded from 8.1% in 2022 to 5.3% in 2023 mainly due to a decrease in energy prices. In quarterly terms, inflation slowed to 2.4% (y-o-y) in the final quarter of 2023 but edged up to 2.5% in the first quarter of 2024, as the disinflation process was

temporarily muted by base effects in the energy sector and the re-establishment of the normal VAT rates for essential food products. Nevertheless, all major goods, including food and non-energy industrial items, contributed substantially to the disinflation process. Services inflation moderated at a much slower pace to 5.0% (y-o-y) in the first quarter of 2024 and remained well above the headline index. On the one hand, prices of services were pushed by strong wage growth, as the average compensation per employee rose by 8.1% in 2023. On the other hand, the strong rebound in foreign tourism also contributed to the sticky services inflation, as prices of accommodation and catering surged significantly more than the average index for services.

Inflation is set to moderate further. Taking into account the recent dynamics in commodity prices and the Commission energy price assumptions over the short-term forecast horizon, headline inflation is set to continue to moderate. The projected increases in real wages and employment are set to keep some pressure on non-tradable goods and services, leading to a slower adjustment in core inflation. All in all, HICP inflation is expected to remain slightly below the EU average.

House prices grew strongly in 2023. Growth in house prices moderated from 12.6% in 2022 to 8.2% in 2023. The growth rate exceeded significantly the EU average, which was estimated at -0.3%. The deflated house price index, adjusted for the private consumption deflator, slowed from 4.8% in 2022 to 3.0% in 2023. In quarterly terms, nominal prices slowed to 7.6% (y-o-y) in the third quarter of 2023 but the rate edged up to 7.8% in the final quarter of the year. In 2023, the number of transactions dropped by 18.7% mainly due to the contraction in the market for existing dwellings. In the final quarter of last year, the number of transactions dropped only by 11.4% (y-o-y) as mortgage rates stabilised and demand started to recover. The share of buyers with foreign residency is estimated at 12.7% of the total market in terms of value in 2023 and 7.6% in terms of transactions. However, in the tourism region of Algarve, the share of non-resident buyers reached nearly 39% of the total value of transactions.

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



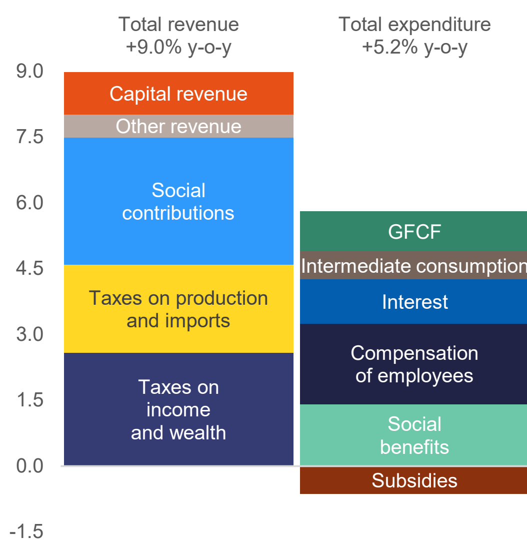
Source: Eurostat.

3. PUBLIC FINANCE DEVELOPMENTS

3.1. FISCAL PERFORMANCE AND OUTLOOK

The general government balance reached a surplus in 2023. After a deficit of 0.3% of GDP in 2022, Portugal's general government balance markedly improved to a surplus of 1.2% of GDP in 2023. Revenue was boosted by the outstanding performance of taxes on income and wealth and social contributions. These developments were underpinned by the robust labour market, dynamic economic activity, and the high inflation for the year. The discretionary increases in both public wages and pensions weighed on expenditure. Interest expenditure also increased in 2023, amidst a higher interest rate environment (see Section 5). Public investment continued to expand. The complete phase-out of COVID-19 temporary emergency measures and the reduced net budgetary impact of energy support measures contributed to containing expenditure, particularly expenditure on social benefits and subsidies.

Graph 3.1: **Revenue and expenditure developments, 2023**



(1) National accounts data. Each category is expressed in terms of the pps. contribution to either total revenue or total expenditure annual (y-o-y) growth.
Source: Portugal's Statistical Institute and European Commission.

Over the forecast horizon, revenue growth is set to slowdown, with expenditure gaining momentum. The general government surplus is forecast [2] to decrease by 0.8 percentage points in 2024 to 0.4% of GDP, and to reach 0.5% of GDP in 2025. The fiscal measures introduced with the 2024 State Budget such as the reform of the personal income tax, the general increase in pensions and the across-the-board update in public wages are expected to negatively impact the general government balance in 2024 and 2025. The developments in the balance also reflect the projected economic slowdown and the moderation in inflation (see Section 2). At the same time, public investment is set to further increase linked to the implementation of the RRP and other EU-funded programmes.

Public debt is set to steadily decline. The public debt-to-GDP ratio reached 99.1% in 2023, down by 13.3 percentage points as compared to 2022, benefiting from both a favourable denominator effect mainly due to high inflation and the recorded primary surplus. Going forward, the pace of debt reduction is expected to slow down. The ratio is forecast at 95.6% in 2024 and 91.5% in 2025. The main drivers for this reduction are the projected primary surpluses and the nominal GDP growth, which is set to continue expanding, albeit at a slower pace with the expected moderation in inflation. The stock-flow adjustment (reflecting the difference between the change in debt and deficit) is expected to contribute with a debt-increasing effect over the forecast horizon (see Annex 2 on the Commission's debt sustainability analysis).

Fiscal outlook risks are on the downside. Portugal's public finances risks relate, among others, to ongoing requests for financial rebalancing of public-private partnerships (PPPs), including those related to the impact of COVID-19 on their activities, and vulnerabilities in some public corporations. More frequent and intense natural hazards faced by Portugal also represent a relevant risk to the country's fiscal outlook. The risks identified for Portugal's macroeconomic outlook (see Section 2), as the significant uncertainty in the external environment, are also risk factors to this fiscal outlook.

(2) According to the Commission 2024 spring forecast, which incorporates the information available in the no-policy-change Portuguese 2024-2028 Stability Programme submitted to the Commission on 30 April 2024.

3.2. POLICY ISSUES

Portugal is implementing measures addressing fiscal sustainability. In 2023, as part of the Portuguese RRP, new procurement models for the national central public procurement system entered into force, a new conceptual model for monitoring the budgetary and financial execution of general government was approved, and a report model was introduced for the disclosure of financial information and performance of state-owned enterprises (SOEs). In addition, preliminary steps were undertaken on the RRP's new fiscal-structural reform, included in the revision of the RRP, on the simplification of the country's tax system. A legal act was approved with a focus on reducing a selected number of tax benefits ([3]). The Portuguese authorities also reported progress on the implementation of the State Accounting Entity and on new pilot projects for the incorporation of programme budgeting in the country's budgetary process. In July 2023, Portugal set up a working group for spending reviews, which already undertook, as part of the 2024 State Budget, a spending review exercise on areas such as public administration resources and specific health expenditures.

The fiscal balance of the health system is increasingly reliant on State Budget transfers. The budget balance of the National Health System (NHS) recorded a deficit of 0.5% of GDP in 2022, a decrease of 0.1 percentage points as compared with 2021. The NHS balance is expected to improve in 2023, according to the authorities' preliminary estimates, to a deficit of 0.2% of GDP. By 2024, and according to the 2024 State Budget, a balanced budget is planned for the NHS. These balance developments mainly stem from the larger current transfers from the State Budget which were of 4.8% of GDP in 2023, EUR 1.2 billion more than in 2022, and are planned to further expand to 4.9% of GDP in 2024. These transfers more than compensate the past and projected increases in the NHS wages and in the acquisition of medical supplies, also reflecting COVID-19 related-expenditure becoming structural. The level of NHS financial arrears reached EUR 141 million, EUR 50 million more than by end 2022.

State-owned enterprises are showing preliminary signs of financial stabilisation. The financial situation of SOEs improved in 2022. According to the authorities' preliminary data, this improvement appears to have continued in 2023. However, SOEs' debt levels are still expected to remain elevated. In terms of relevant SOEs-related operations in 2023, additional losses from non-recoverable credits held by *Parvalorem* S.A., amounted to EUR 916 million (0.3% of GDP). In addition, a capital expenditure of EUR 166.2 million (0.1% of GDP) was also recorded in 2023 related to EFACEC's reprivatisation process. Net payments to PPPs decreased in 2023, mainly related to lower payments to PPPs operating in the motorway and the health sector. A decrease in outstanding PPPs' net payments is forecast for 2023 and beyond. Nonetheless, according to the authorities, potential new infrastructure projects, such as the new Lisbon hospital and a high-speed railway, may result in an increase in net payments in the medium term. Financial rebalancing requests related to the impact of COVID-19 on PPPs are still under assessment or discussion.

([3]) Commission Implementing Decision of 22 December 2023 (C(2023) 9290 final) on the authorisation of the disbursement of the third and fourth instalments of the nonrepayable support and the third and fourth instalments of the loan support for Portugal.

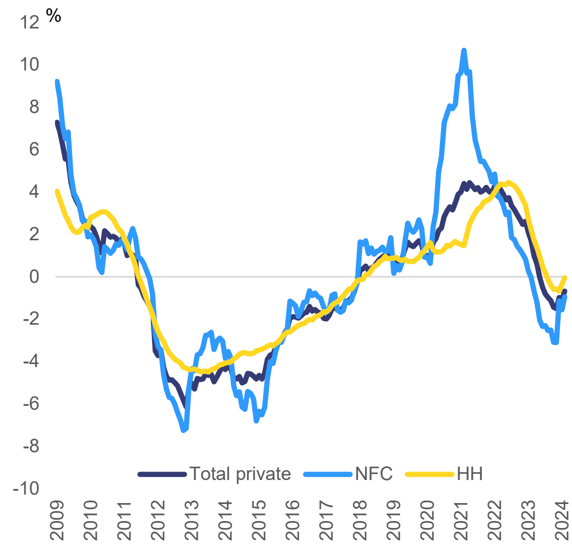
4. FINANCIAL SECTOR DEVELOPMENTS

Portuguese banks recorded strong profits. Banks have fully seized the cyclical opportunity to post strong profits. The profitability metrics were driven by high interest income and wide interest margins. Profitability increased to the highest level since the financial crisis, with banks registering aggregate returns on assets and equity of 0.94% and 10.6%, respectively, as at September 2023. The strong increase was driven by the asymmetric passthrough of interest rate hikes on banks' credits relative to deposits. In this respect, the large share of loans on variable rates in Portugal allowed banks to perform even better than most EU peers. Interest rates on deposits accelerated since the second half of 2023, but at end-2023 remained well below the euro-area average (1.84% vs 2.42% for households' deposits and 2.97% vs 3.39% for non-financial corporation's (NFCs') deposits), among possible reasons because of the ample liquidity buffers held by Portuguese banks. Impairments remained contained, as credit quality did not deteriorate materially despite the increased pressure on the debt-servicing capacity of some more vulnerable households and firms. In the third quarter of 2023, despite operating costs increasing by 9.5% y-o-y, the cost-to-income ratio declined to 36.5%, well below the euro-area average of 53.5%.

Going forward, several factors could challenge the current profitability levels. Higher costs on deposits, and possible upcoming declines in official and EURIBOR rates, could impact bank's margins in the coming quarters. Furthermore, new loan origination remains subdued, especially for housing loans, possibly challenging banks' future revenues. Finally, a significant share of Portuguese banks' income came from deposits held at the ECB, which will likely yield significantly lower returns in the future and impairment charges could possibly increase, as the outlook for credit risk remains uncertain.

Bank credit continues its downward course. 2023 was a year of mixed developments in bank lending. While the overall credit supply remained stable, demand was subdued for most of 2023. Bank lending to the local corporate sector remained negative throughout 2023, decreasing by 1.1% y-o-y by the end of 2023. A closer look at the sectoral distribution reveals a contrasting picture. The contraction in credit was particularly pronounced in the manufacturing sector (-9.1% y-o-y), whereas professional and administrative activities sector experienced a credit growth acceleration in the second half, ending the year with a 6.2% increase. The NFC segment related to construction and real estate activities closed 2023 with a 1.8 pps increase, though the dynamics of the trend were pointing downward. Similarly to NFCs, loans to households decelerated. The stock of bank credit to households decreased by 0.7% y-o-y by end-2023, reflecting mainly the deceleration in the housing loans segment (-1.3% y-o-y) but also some positive dynamics in consumer loans (+6% y-o-y). New housing loans (excluding renegotiations but including loan transfers) dropped overall some 12% in 2023, reflecting mainly the high cost of credit for house purchase.

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



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

The NPL ratio converges towards euro area levels. Following a modest uptick in the gross NPL ratio during the first half of 2023, the second half of the year was characterised by a decrease in the ratio. The decline was largely attributed to write-offs and sales of NPL portfolios to third parties. Notably, while the NPL ratio for NFCs experienced a significant decline from 6.5% at end-2022 to 5.9% in September 2023, the NPL ratio for households remained stable, albeit at a relatively low level. The overall gross NPL ratio stood at 2.9%, marking a 0.1 pps decrease from end-2022. However, the share of Stage 2 loans, indicating higher risk, saw a marginal increase from 10.3% to 10.6% over the same period, primarily driven by a rise in the house-purchase loan segment. The gap in NPL ratios with the euro area has considerably narrowed since 2019, and Portuguese banks have shown progressive improvement in their coverage ratio in recent years, which at 57.0% is comfortably above the EA average of 44.1%.

Table 4.1: **Soundness indicators**

	2017	2018	2019	2020	2021	2022	2023	EU	Median
NFC credit growth (year-on-year % change)	-0.3	1.8	0.9	9.5	4.5	0.8	-1.2	-	2.4
HH credit growth (year-on-year % change)	-0.2	0.9	1.2	1.6	3.8	3.4	-0.7	-	1.4
Financial soundness indicators:[1]									
Non-performing loans (%)	13.3	9.4	6.1	4.9	3.6	3.0	2.9	1.8	1.8
Capital adequacy ratio (%)	15.2	15.2	16.7	18.1	18.0	18.1	18.9	19.6	20.1
Return on equity (%)[2]	-0.8	2.7	4.3	0.0	4.9	8.7	14.1	9.9	13.2
Cost-to-income ratio (%)[1]	52.9	60.2	59.2	56.0	51.6	48.8	36.5	52.8	44.9
Loan-to-deposit ratio (%)[1]	78.9	76.2	76.4	72.1	68.9	71.8	73.2	93.3	80.2

1-3 | 4-10 | 11-17 | 18-24 | 24-27 — Colours indicate performance ranking among 27 EU Member States.

(1) Last data: Q3 2023
(2) Data is annualised
(3) Data available for EA countries only, EU average refers to EA
Source: ECB, Eurostat.

Banks improved further their capital positions and maintained comfortable levels of liquidity. Large retained earnings, coupled with a positive denominator effect i.e., declining total assets, allowed banks to strengthen their capital buffers. At end-2023, total own funds stood at 18.9% (+0.8 pp y-o-y) and the CET1 ratio was 16.4% (+1.0 pp y-o-y), well above regulatory requirements and in line with the EA average of 16.0%. Banks continued issuing MREL ([4])-eligible liabilities and met their MREL requirements by the first quarter of 2024. The central bank introduced a new sectoral systemic risk buffer of 4% (in force as of October 2024) on real estate exposures of banks using an internal ratings-based approach, but it does not expect it to impact materially banks' capital headroom. Liquidity remained ample, despite the reduction of banks' central bank liabilities and depositors' migration towards higher yielding term deposits. In September 2023, local lenders reported a liquidity coverage ratio (LCR) of 232.8%, 3 pps higher than at end-2022. Finally, the outflow of deposits into government savings certificates came to a halt since mid-2023.

Demand for housing loans has dropped but borrowers actively seek favourable credit conditions. The annual rate of change in the stock of bank credit to local households dropped to -0.7% by end-2023,

([4]) Minimum requirement for own funds and eligible liabilities.

influenced by factors such as high interest rates, lower consumer confidence, and weaker housing market prospects. However, the real estate exposure of the banking sector, as a percentage of total assets, rose to 35.6% in September 2023, mainly due to a decrease in the system's total assets. Households have shown some increased sensitivity to mortgage interest rates over the last year, prompting many borrowers to actively seek out more favourable credit conditions through exploring borrowing options across different banks. In parallel, in 2023 the share of new housing loans with an interest rate fixation period longer than one year surged from 23% to 73%, as borrowers sought protection from rising interest rates. Regarding loans to NFCs secured by real estate, this segment totalled EUR 25 billion and accounted for around 30% of total NFC loans, the fourth lowest figure in the euro area. This amount is significantly smaller than the residential mortgage portfolio of Portuguese banks, which stands at EUR 100.2 billion. The commercial real estate (CRE) market in terms of pricing and contraction expectations looks comparatively more favourable than in other EA Member States. Furthermore, given the higher capital requirements for CRE credit compared to RRE credit, banks have a comparatively better shock absorption capacity when it comes to managing their CRE exposures.

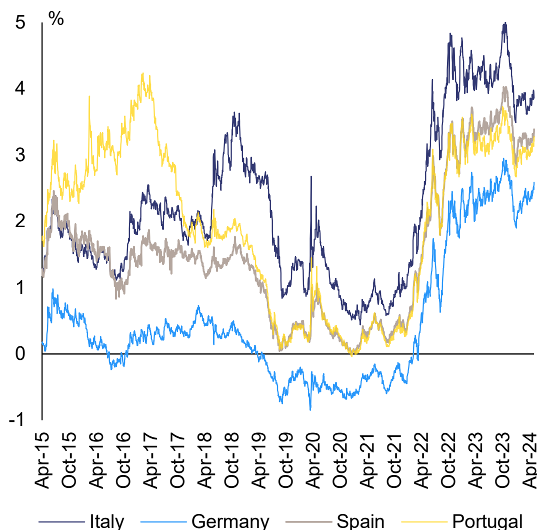
A safety net ensures borrowers will have the capacity to continue repaying mortgage loans. With the goal of alleviating the impact of high interest rates on the residential mortgage market, the government has put in place additional support measures for borrowers, such as the extension until end of 2024 of the temporary suspension of early repayment fees for variable-rate mortgages. Back in October 2023, the authorities introduced the option to reduce and stabilise the mortgage instalments for housing loans for a period of two years. Under this scheme, borrowers had, until 31 March 2024, the possibility to request the adjustment of their monthly instalments using a reference rate equal to 70% of the 6-month Euribor. Although the alleviating impact of these measures on households is still uncertain, their structure does not compromise the financial soundness of Portuguese banks and, in the long run, decreases the potential build-up of NPLs.

Risks to financial stability relate to both domestic and external factors. The banking sector displayed an exceptionally strong performance in 2023, posting some of the strongest results of the past two decades. Nevertheless, risks to the financial sector remain present in the background, also compounded by geopolitical uncertainty leading to risk premia increases in the international financial markets. Lastly, the continued rising prices of residential real estates in Portugal warrant close monitoring. Several factors such as strong non-residents ownership and participation in the market and supply bottlenecks will continue playing a supportive role in the real estate market.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Financing needs are expected to remain broadly stable by end-2024. Financing needs decreased in 2023 to EUR 19.9 billion (7.5% of GDP), down by nearly EUR 5 billion as compared to 2022. The improvement in the budget balance on a cash basis in 2023 is the main factor for this decrease (see Section 3). With this improvement, alongside the lower net acquisitions of financial assets, financing needs in 2023 were considerably below the EUR 24.1 billion (9.1% of GDP) expected for the year. In 2024, financing needs are projected to remain broadly unchanged at EUR 20.4 billion (7.4% of GDP). The expected deterioration in the budget balance and the increase in the net acquisitions of financial assets compensate the scheduled reduction in debt redemptions for the year. Portugal's cash buffer (as measured by general government deposits) contracted by the end of 2023 to EUR 11.4 billion (4.3% of GDP), from EUR 13.9 billion in 2022 (5.7% of GDP). It is projected at EUR 12.0 billion (4.3% of GDP) in 2024, covering more than one third of the financing needs for the year.

Graph 5.1: **10-year government bond yields**



Source: European Commission.

Financial markets perception of Portugal's sovereign debt improved. Portugal continues to enjoy a favourable market perception. The 10-year Portuguese government bond yields stood at 3.2% by the cut-off date of this report. Since December 2021 ([5]) yields have increased by 2.7 percentage points, with a preliminary reversal in the trend observed by end 2023. Spreads against the German bund have consistently narrowed, with Portugal trading below Portugal's main euro area peers (see Graph 5.1). Credit-rating agencies improved their assessment of Portugal's sovereign debt. The improved budgetary performance and the decline in the public debt-to-GDP ratio are the main factors referred to in their assessment. Since November 2023, Moody's upgraded its rating by two notches from 'Baa2' to 'A3', changing its outlook from 'positive' to 'stable'. Standard and Poor's followed in March 2024 with a one notch rating increase, both from 'BBB+' to 'A-', and confirming its outlook at 'positive'. DBRS and Fitch confirmed their rating of 'A' and 'A-', respectively, with a 'stable' outlook.

Portugal's financing strategy is to re-focus on government bonds issuances. In 2023, net issuances of retail debt, through saving certificates ('*Certificates de Aforro*'), reached a historical high of EUR 10.2 billion. At the same time, government bonds and T-bills had a lower weight as financing sources. Issuances of government bonds reached EUR 9.4 billion while net issuances of T-bills were negative, at EUR 4.6 billion. A total of EUR 4.3 billion (1.6% of GDP) – of which, EUR 3.6 billion in grants and EUR 0.7 in loans – was disbursed to Portugal in 2023 as part of the Portuguese recovery and resilience plan (RRP) ([6]). In addition, in December 2023 a pre-financing of the REPowerEU funds of EUR 171 million (0.1% of GDP) in grants was disbursed to Portugal. Private placements surged in 2023, with syndications and auctions as the main debt issuance methods. The investor base was stable and diversified across regions and types. After their surge in

([5]) In December 2021, the ECB started a path of monetary policy normalisation. Since then, and until the cut-off date of this report of 30 April 2024, it has raised its main policy rates by 4.5 percentage points and has kept them unchanged since October 2023. It has also ended its net purchases under the pandemic emergency purchase programme (PEPP) and started unwinding the portfolio acquired under the asset purchase programme (APP).

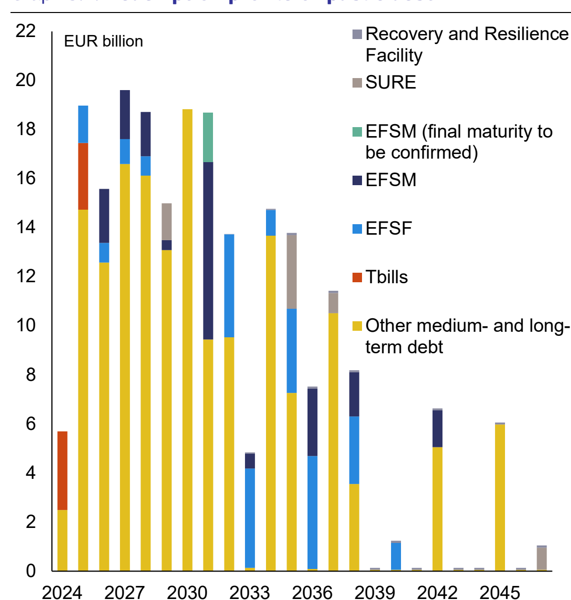
([6]) Commission Implementing Decision of 1 February 2023 (C(2023) 861 final) on the authorisation of the disbursement of the second instalment of the non-repayable support and the second instalment of the loan support for Portugal, and; Commission Implementing Decision of 22 December 2023 (C(2023) 9290 final) on the authorisation of the disbursement of the third and fourth instalments of the nonrepayable support and the third and fourth instalments of the loan support for Portugal.

the first half of 2023, and later abrupt decline in take up in the third quarter of 2023 ([7]), retail debt instruments are expected not to have an important role as financing source going forward. Debt financing for 2024 ([8]) is planned to mainly rely on the issuance of government bonds, combining syndications with auctions, and on net issuances of T-bills. By the cut-off date of this report, Portugal has already executed nearly half of its funding plan for 2024. In January 2024, Portugal issued a new benchmark 10-year government bond with a coupon of 2.9%, for a nominal amount of EUR 4 billion. It achieved nearly a fivefold over-subscription, with investors being predominantly banks based in the United Kingdom, France, Italy and Spain.

Portugal committed to a debt management strategy targeting risk contention. Portugal continued to pursue a strategy aimed at containing interest expenditures and smoothening the debt redemption profile. Debt redemptions are expected to peak in the medium term (see Graph 5.2), mainly owing to outstanding Portuguese government bonds series maturing between 2025 and 2030. To contain these peaks and limit refinancing risks, Portugal undertook operations, such as buy-backs and government exchange offers and focused its debt issuances on longer maturities. In 2023, operations to buy back or exchange government bond series covered approximately EUR 4.4 billion government bonds otherwise maturing between 2024 and 2027. The average residual maturity of Portugal's public debt stood at 7.2 years by the end of 2023, and it is expected to decline to 7 years by the end of 2024.

Debt sustainability risks remain high in the medium-term. The Portuguese public debt-to-GDP ratio reached 99.1% in 2023 and is expected to continue declining in 2024 and 2025, although remaining at a high level (see Section 3). The implicit interest rate on Portugal's public debt reached 2.1% by end 2023, 0.4 percentages points higher than in 2022, and is forecast to reach 2.3% in 2024, amidst a higher interest rate environment. According to the Commission's debt sustainability analysis (see Annex 2), medium-term risks to Portugal's fiscal sustainability are high overall, and low in both the short- and long-term.

Graph 5.2: **Redemption profile of public debt**



(1) Last update: 19-04-2024.
Source: Portuguese Treasury and Debt Agency (IGCP).

Portugal retains the capacity to service its debt. The country's capacity to repay is supported in the short term by its comfortable cash buffer, the maturity structure of its debt, most of which with fixed rates, stable and diversified financing sources, and its debt currency denomination. Financial assistance loans were fully repaid to the IMF in December 2018. The outstanding debt to the European Financial Stability Facility (EFSF) is EUR 25.3 billion. To the European Financial Stabilisation Mechanism (EFSM) debt outstanding is EUR 22.3 billion, after the repayment of EUR 1.5 billion executed in November 2023. The next repayments to the EFSF and the EFSM are scheduled for 2025 and 2026, respectively (see Graph 5.2).

([7]) In June 2023 a new series of saving certificates, the so-called '*F series*' was created replacing the '*E series*.' This new series has a longer maturity with a narrower interest bandwidth: certificates have a maturity of 15 years with interest fluctuating between 0% to 2.5%. For the previous '*E series*', certificates had a 10 maturity with interest rate fluctuating between 0% to 3.5%.

([8]) Portuguese Treasury and Debt Agency, 'Financing Programme of the Republic of Portugal for 2024 – update for the second quarter of 2024', 26 March 2024.

ANNEX 1: MAIN MACROECONOMIC AND FINANCIAL INDICATORS

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

	2019	2020	2021	2022	2023	2024	2025
Real economy			*(percent change)*				
Real GDP	2.7	-8.3	5.7	6.8	2.3	1.7	1.9
Domestic demand incl. inventories	3.1	-5.4	5.9	4.4	1.4	2.3	2.1
Private consumption expenditure	3.3	-7.0	4.7	5.6	1.7	1.8	1.9
Government consumption expenditure	2.1	0.3	4.5	1.4	1.0	2.1	1.2
Gross fixed capital formation	5.4	-2.2	8.1	3.0	2.5	3.9	3.7
Exports of goods and services	4.1	-18.6	12.3	17.4	4.1	2.8	2.5
Imports of goods and services	4.9	-11.8	12.2	11.1	2.2	4.1	3.2
Contribution to growth			*(percentage points)*				
Domestic demand (excl. inventories)	3.4	-4.9	5.4	4.4	1.8	2.2	2.1
Foreign trade	-0.4	-3.0	-0.2	2.3	0.9	-0.6	-0.3
Changes in inventories	-0.3	-0.5	0.6	0.1	-0.3	0.0	0.0
Inflation			*(percent change)*				
GDP deflator	1.7	2.0	1.9	5.0	7.1	2.6	2.1
HICP	0.3	-0.1	0.9	8.1	5.3	2.3	1.9
Labour market			*(percent change, unless otherwise stated)*				
Unemployment rate (% of labour force)	6.7	7.0	6.7	6.2	6.5	6.5	6.4
Employment	0.8	-1.8	2.0	1.5	0.9	1.0	0.9
Compensation per employee	4.8	1.5	5.1	5.7	8.1	3.3	2.8
Labour productivity	1.9	-6.6	3.7	5.2	1.4	0.7	0.9
Unit labour costs	2.8	8.7	1.3	0.5	6.6	2.6	1.8
Public finance			*(percent of GDP)*				
General government balance	0.1	-5.8	-2.9	-0.3	1.2	0.4	0.5
Total revenue	42.6	43.4	44.6	43.8	43.5	43.8	44.0
Total expenditure	42.5	49.2	47.5	44.1	42.3	43.4	43.5
General government primary balance	3.1	-2.9	-0.5	1.6	3.4	2.6	2.7
Gross debt	116.6	134.9	124.5	112.4	99.1	95.6	91.5
Balance of payments			*(percent of GDP)*				
Current external balance	0.1	-1.2	-1.0	-1.3	1.3	0.8	0.6
Ext. bal. of goods and services	0.5	-2.1	-2.8	-2.4	0.8	0.4	0.2
Exports goods and services	43.5	37.0	41.4	49.6	47.4	47.6	47.8
Imports goods and services	43.1	39.2	44.2	52.0	46.6	47.2	47.5
			(EUR bn)				
Nominal GDP	214.4	200.5	216.1	242.3	265.5	277.1	288.3

Source: European Commission.

ANNEX 2: DEBT SUSTAINABILITY ANALYSIS

This annex assesses fiscal sustainability risks for Portugal over the short, medium and long term. It follows the multi-dimensional approach of the European Commission's 2023 Debt Sustainability Monitor, updated based on the Commission 2024 spring forecast.

1 – Short-term risks to fiscal sustainability are low. The Commission's early-detection indicator (S0) does not point to short-term fiscal risks (Table A2.2) ([9]). Government gross financing needs are expected to decrease and stabilise at around 5% of GDP on average over 2024-2025 (Table A2.1, Table 1). Financial markets' perceptions of sovereign risk are investment grade, as confirmed by main rating agencies.

2 – Medium-term fiscal sustainability risks appear high.

The DSA baseline shows that the government debt ratio is expected to decline but remain at a high level in the medium term (at 77% of GDP in 2034) (Graph 1, Table 1) ([10]). The debt reduction is supported by the assumed structural primary surplus (excluding changes in cost of ageing) of 2.2% of GDP. This appears ambitious compared with past performance, suggesting limited fiscal room of manoeuvre ([11]). The debt decline also benefits from a still favourable but declining snowball effect, notably thanks to the impact of Next Generation EU (NGEU). Finally, government gross financing needs are expected to slightly increase by the end of the projection period in 2034 around 7% of GDP, above the average over 2024-2025.

The baseline projections are stress-tested against four alternative deterministic scenarios to assess the impact of changes in key assumptions (Graph 1). For Portugal, all the stress tests scenarios would lead to higher debt ratios in 2034 compared to the baseline, with particularly adverse developments under the *historical structural primary balance (SPB) scenario* (i.e. the SPB returns to its historical 15-year average of 0.5% of GDP). Under this stress scenario, the debt ratio would be higher than under the baseline by about 13 pps. of GDP in 2034. Under the *adverse interest-growth rate differential scenario* (i.e. the interest-growth rate deteriorates by 1 pp. compared with the baseline), the debt ratio would be higher than under the baseline by around 7 pps. of GDP in 2034. A similar adverse impact on the debt ratio (about 5 pps.) is projected for 2034 under the *lower structural primary balance scenario* (i.e. the projected cumulative improvement in the SPB over 2023-2024 is halved). Under the *financial stress scenario* (i.e. interest rates temporarily increase by 1.1 pps. compared with the baseline) the debt ratio would be higher by only around 1 pp. in 2034.

The stochastic projections indicate medium risks, pointing to moderate sensitivity of these projections to plausible unforeseen events ([12]). These stochastic simulations indicate a 20% probability that the debt ratio will be higher in 2028 than in 2023, implying medium risks given the current high debt level. In addition, the uncertainty surrounding the baseline debt projections is high (as measured by the

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

([10]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline include in particular: (i) a structural primary surplus, before changes in ageing costs, of 2.2% of GDP from 2024 onwards; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years ahead); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10; (iv) real GDP growth rates from the Commission 2023 autumn forecast, followed by the EPC/OGWG 'T+10 methodology projections between T+3 and T+10 (average of 1.1%); (v) ageing costs in line with the 2024 Ageing Report (European Commission, Institutional Paper 279, April 2024). For information on the methodology, see the 2023 Debt Sustainability Monitor (European Commission, Institutional Paper 271, March 2024).

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

([12]) The stochastic projections show the joint impact on debt of 10,000 different shocks affecting the government's budgetary position, economic growth, interest rates and exchange rates. This covers 80% of all the simulated debt paths and therefore excludes tail events.

difference between the 10th and 90th debt distribution percentiles), as the debt ratio is expected to be within a large range of 46 pps. of GDP in five years' time (Graph 2).

3 – Long-term fiscal sustainability risks appear overall low. This assessment is based on the combination of two fiscal gap indicators, capturing the required fiscal effort to stabilise debt (S2 indicator) and bring to 60% of GDP (S1 indicator) over the long term ([13]). This assessment is mainly driven by the favourable initial budgetary position, partly offsetting the projected increase in ageing costs. Hence, these results are conditional on the country maintaining a sizeable SPB over the long term, and duly implementing legislated pension reforms.

The S2 indicator points to low fiscal sustainability risks. The indicator shows that, relative to the baseline, the SPB could relax its fiscal position by 1.5 pps. of GDP and still ensure debt stabilisation over the long term. This result is underpinned by the favourable initial budgetary position (contribution of -1.7 pps. of GDP), partially offset by the projected increase in ageing-related public spending (0.2 pp.). Ageing cost developments are primarily driven by a projected increase in health-care and long-term care spending (contribution of +1.6 pps. of GDP), partly offset by the projected decrease in public pension expenditure (-1.5 pps.) (Table A2.1, Table 2).

The S1 indicator points to low fiscal sustainability risks. The indicator shows that Portugal does only need to improve its fiscal position by 0.4 pp. of GDP to reduce its debt to 60% of GDP by 2070. This result is mainly driven by the favourable initial budgetary position (contribution of -2.2 pps. of GDP), which partly offset by the projected ageing-related public spending (1.9 pps.) and the debt requirement (0.7 pp.) (Table A2.1, Table 2). ([14])

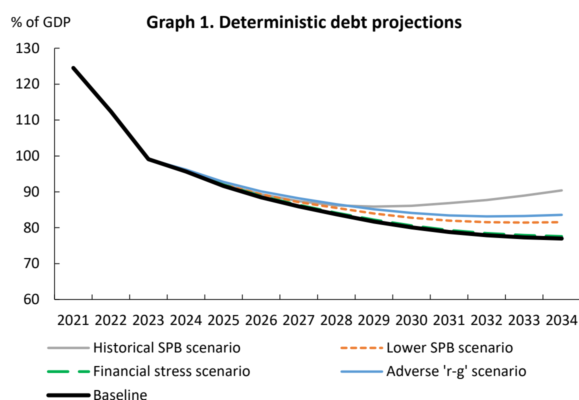
4 – Finally, several additional risk factors need to be considered in the assessment. On the one hand, risk-increasing factors are related to country-specific factors as the ongoing requests for a financial rebalancing of PPPs and vulnerabilities in some public corporations, and Portugal's negative net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

([13]) The S2 fiscal sustainability indicator measures the permanent SPB adjustment in 2025 that would be required to stabilise public debt in the long term. It is complemented by the S1 indicator, which measures the permanent SPB adjustment in 2025 to bring the debt ratio to 60% by 2070. For both the S1 and S2 indicators, the risk assessment depends on the amount of fiscal consolidation needed: 'high risk' if the required effort exceeds 6 % of GDP, 'medium risk' if it is between 2% and 6% of GDP, and 'low risk' if the effort is negative or below 2% of GDP. The overall long-term risk classification combines the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 if it signals a higher risk than S2. See the 2023 Debt Sustainability Monitor for further details.

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

Table A2.1: **Debt sustainability analysis**

Table 1. Baseline debt projections	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Gross debt ratio (% of GDP)	**124.5**	**112.4**	**99.1**	**95.6**	**91.6**	**88.5**	**86.0**	**83.7**	**81.7**	**80.1**	**78.8**	**77.9**	**77.3**	**77.0**
Changes in the ratio	-10.3	-12.1	-13.3	-3.5	-4.0	-3.2	-2.5	-2.2	-2.0	-1.6	-1.3	-0.9	-0.6	-0.3
of which														
Primary deficit	0.5	-1.6	-3.4	-2.6	-2.4	-2.2	-1.9	-1.6	-1.4	-1.2	-0.9	-0.6	-0.4	-0.2
Snowball effect	-7.3	-11.6	-7.6	-2.0	-1.7	-1.0	-0.7	-0.6	-0.6	-0.5	-0.4	-0.3	-0.2	-0.1
Stock-flow adjustments	-3.5	1.1	-2.3	1.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs (% of GDP)	12.1	10.7	4.0	5.4	5.1	5.5	5.7	5.7	5.6	5.2	7.5	7.5	7.3	6.6



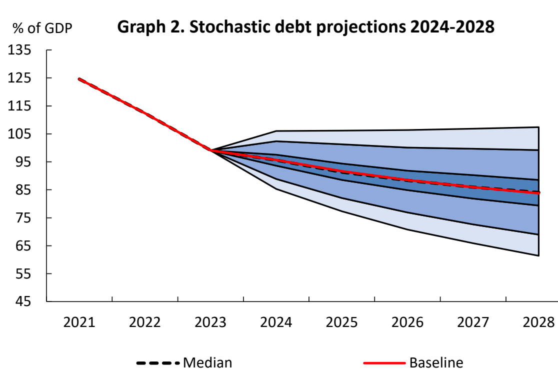


Table 2. Breakdown of the S1 and S2 sustainability gap indicators

			S1	S2
Overall index (pps. of GDP)			**0.4**	**-1.5**
of which				
	Initial budgetary position		-2.2	-1.7
	Debt requirement		0.7	
	Ageing costs		1.9	0.2
	of which	*Pensions*	0.6	-1.5
		Health care	1.0	1.2
		Long-term care	0.3	0.4
		Education	0.0	0.1

Source: European Commission services.

Table A2.2: **Heatmap of fiscal sustainability risks**

Short term	Medium term - Debt sustainability analysis (DSA)								Long term		
			Deterministic scenarios								
Overall (S0)	Overall		Baseline	Historical SPB	Lower SPB	Adverse 'r-g'	Financial stress	Stochastic projections	S2	S1	Overall (S1 + S2)
LOW	HIGH	Overall	MEDIUM	HIGH	MEDIUM	MEDIUM	MEDIUM	MEDIUM	LOW	LOW	LOW
		Debt level (2034), % GDP	77.0	90.4	81.6	83.6	77.6				
		Debt peak year	2024	2024	2024	2024	2024				
		Fiscal consolidation space	19%	45%	27%	19%	19%				
		Probability of debt ratio exceeding in 2028 its 2023 level						20%			
		Difference between 90th and 10th percentiles (pps. GDP)						46.0			

(1) Debt level in 2034. Green: below 60% of GDP. Yellow: between 60% and 90%. Red: above 90%. (2) The debt peak year indicates whether debt is projected to increase overall over the next decade. Green: debt peaks early. Yellow: peak towards the middle of the projection period. Red: late peak. (3) Fiscal consolidation space measures the share of past fiscal positions in the country that were more stringent than the one assumed in the baseline. Green: high value, i.e. the assumed fiscal position is plausible by historical standards and leaves room for corrective measures if needed. Yellow: intermediate. Red: low. (4) Probability of debt ratio exceeding in 2028 its 2023 level. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) the difference between the 90th and 10th percentiles measures uncertainty, based on the debt distribution under 10000 different shocks. Green, yellow and red cells indicate increasing uncertainty. (For further details on the Commission's multidimensional approach, see the 2023 Debt Sustainability Monitor)

Source: European Commission (for further details on the Commission's multidimensional approach, please see the 2023 Debt Sustainability Monitor).

ACKNOWLEDGMENTS

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The report was prepared in liaison with staff from the ECB ([16]). Staff from the European Stability Mechanism (ESM) also provided comments.

This report reflects information available and policy developments that have taken place until 30 April 2024. Therefore, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2024 Spring forecast released on 15 May 2024 (with cut-off date 30 April 2024).

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

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([15]) The executive summary of this report was adopted as Commission Communication C(2024)4001 on 18 June 2024. The rest of the report reflects the findings of the Staff Working Document (SWD(2024)401) accompanying this communication.

([16]) 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.

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