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Post-Programme Surveillance Report

Portugal, Spring 2023

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European Commission
Directorate-General for Economic and Financial Affairs

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Portugal, Spring 2023

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Institutional Paper 206

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

This report reflects information available and policy developments that have taken place until 28 April 2023. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 spring forecast released on 15 May 2023 (with cut-off date 28 April 2023).

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([1]) The executive summary of this report was adopted as Commission Communication C(2023)4003 on 22 May 2023. The rest of the report reflects the findings of the Staff Working Document (SWD(2023)652) accompanying this communication.
([2]) European Central Bank (ECB) staff participated in this mission, and the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

ABBREVIATIONS

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

EXECUTIVE SUMMARY

The 17th post-programme surveillance (PPS) mission to Portugal took place from 27 to 30 March 2023*. This mission involved European Commission staff in liaison with European Central Bank (ECB) staff. European Stability Mechanism (ESM) staff participated on aspects relating to the ESM's Early Warning System.*

Since the conclusion of the previous PPS mission in September 2022, Portugal's economy continued to grow despite adverse external shocks. *Real GDP growth picked up from 5.5% in 2021 to 6.7% in 2022, reflecting a significant impetus from the lifting of COVID-19 restrictions in early 2022 and a strong recovery in foreign tourism. In quarterly terms, real GDP growth weakened substantially after the first quarter of 2022 but remained above the euro area average and the outlook appears more favourable compared to the projections presented in the previous PPS report. The balance of risks remains on the downside, reflecting significant global risks and uncertainty as well as rising interest rates. Employment is expected to continue growing at a relatively slow pace as both employment and activity rates have already reached record highs. Unemployment is also set to decrease after temporary hikes in late 2022 and early 2023. After reaching a historic high in the last quarter of 2022, inflation is expected to moderate in 2023-2024, helped by a drop in commodity prices which is only partly counterbalanced by rising wage pressures.*

Portugal's public deficit improved significantly in 2022, outperforming government's plans*. After a deficit of 2.9% of GDP in 2021, Portugal recorded a deficit of 0.4% of GDP in 2022. Government revenues benefited from the strong economic rebound, the resilient labour market, and the high inflation, while the phase-out of COVID-19-related measures contributed to curb expenditure. The public deficit is projected to narrow to 0.1% of GDP in 2023 and remain unchanged in 2024. Challenges to Portugal's public finances relate notably to contingent liabilities linked to publicly guaranteed credit lines, persistent upward pressures on current expenditures, namely on the public wage bill and those emerging from the high inflation and demographic ageing, and ongoing processes of public-private partnerships (PPPs) rebalancing requests. Portugal adopted in 2022 measures to cushion the impact of energy price inflation on households and firms. The government announced in early 2023 additional fiscal policy measures aimed at mitigating the impact of inflation on households' purchasing power. Key fiscal-structural reforms are yet to be implemented, as those addressing the financial sustainability and resilience of the National Health Service and state-owned enterprises, and those improving the effectiveness of the tax and social protection systems.*

Portugal's financial sector remained resilient to past external shocks as banks continue to improve their performance. *Banks' profitability increased in 2022, helped by higher net interest income and by lower new provisions and impairments. The rising Euribor translated into higher interest income on banks' predominant variable-rate loans, whereas interest expenses on deposits did not increase at the same pace, given banks' ample liquidity reserves, only mildly affected by recent deposit outflows. Banks also made further progress in increasing their cost-efficiency and continued to reduce the ratio of non-performing loans. Nevertheless, geopolitical tensions and volatility in international financial markets continue to fuel uncertainty. At the same time, new mortgage borrowers' risk profiles have improved markedly as a result of the macroprudential recommendations by Banco de Portugal. The government also implemented measures to prevent that a potential increase in debt service results in higher defaults.*

Portugal retains the capacity to service its debt. *Despite a number of challenges, the economic, fiscal and financial situation in Portugal is overall stable. Portugal's public debt-to-GDP ratio contracted in 2022 to 113.9% and it is projected to continue on a downward path in 2023 and 2024, benefiting also from a favourable denominator effect due to high inflation. According to the Commission's debt sustainability analysis, Portugal is assessed to face low risks in both the short- and long- term, while risks remain high in the medium-term. Portugal's financing needs started to decrease in 2022, still staying above pre-pandemic levels, and are expected to remain broadly unchanged in 2023. An EFSM maturity of EUR 1.5 billion is scheduled for the end of 2023, with the next EFSF loan repayment of EUR 1.5 billion in 2025. Portugal's continued to enjoy a favourable market access amid a tightening of financing conditions.*

1. Introduction 7

2. Economic developments 8

3. Public finance developments 11

3.1. Fiscal performance and outlook 11

3.2. Policy issues 12

4. Financial sector developments 14

5. Sovereign financing and capacity to repay 17

A1. Main macroeconomic and financial indicators 20

A2. Debt sustainability analysis 24

LIST OF TABLES

4.1. Financial stability indicators 14

LIST OF GRAPHS

2.1. Real GDP growth and components 8

2.2. Current account balance 9

2.3. Employment evolution by sectors 9

2.4. HICP and House Price Index 10

3.1. Revenue and expenditure developments, 2022 11

4.2. Share of new loans for house purchase with a floating rate or an initial rate fixation period of ≤1 year 15

1. INTRODUCTION

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

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the seventeenth post-programme surveillance (PPS) mission to Portugal. The mission took place during 27-30 March 2023. Staff from the European Stability Mechanism (ESM) participated in the meetings on aspects related to the ESM's Early Warning System. IMF staff also participated in the meetings. Under PPS, the Commission carries out regular review missions to EU Member States that have had an EU-supported financial assistance programme. The objective of the PPS missions is to assess the economic, fiscal and financial situation to ensure the Member State maintains its capacity to service its debt to the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF).([3])

This report reflects information available and policy developments that have taken place until 28 April 2023. The macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2023 spring forecast released on 15 May 2023 (with cut-off date 28 April 2023).

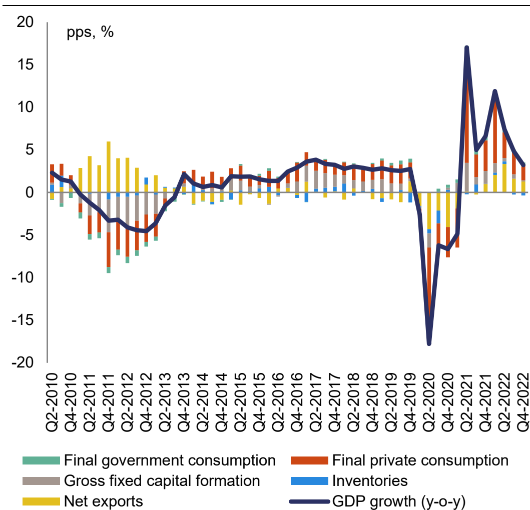
([3]) Under Regulation (EU) N°472/2013, PPS will continue until at least until 75% of the financial assistance received under the programme has been repaid. Under the current repayment schedule, PPS on Portugal will last until 2035.

2. ECONOMIC DEVELOPMENTS

Portugal's economic growth picked up from 5.5% in 2021 to 6.7% in 2022, helped by a strong recovery in foreign tourism. The rebound in private consumption and export of services, particularly tourism, kept overall GDP growth at sound pace while investment growth weakened from 8.7% in 2021 to 3.0% in 2022 as business sentiments deteriorated substantially across Europe. As of 2022, real GDP had moved 3.2% above the 2019 pre-pandemic levels but was about 3% below the trajectory projected before the outbreak of COVID-19 in early 2020.

In the course of 2022, economic conditions deteriorated substantially after the rebound early in the year. The GDP growth rate slowed from 2.3% (q-o-q) in 2022-Q1 to 0.2% in 2022-Q2 and 0.3% in each of the last two quarters of the year. This slowdown was driven by the normalisation of the economic activity after the initial impetus from the relaxation of pandemic-related restrictions as well as the disruption in global supply chains, particularly on energy and food markets, as a result of Russia's war of aggression against Ukraine.

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



Source: INE.

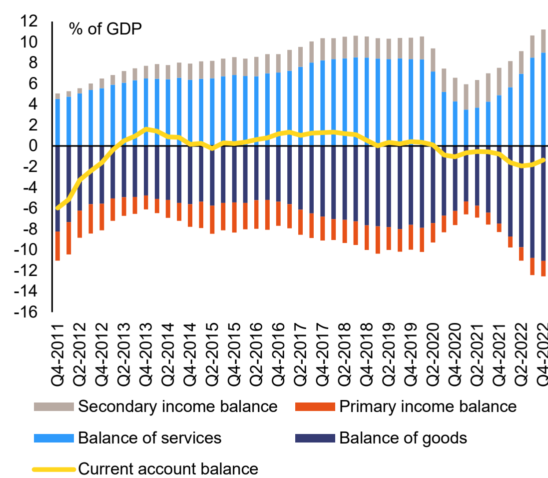
Annual economic growth is projected to slow down in 2023 but the outlook appears somewhat more favourable in comparison to the scenario presented in the previous PPS report. Data for the first quarter of 2023 show that household demand remained constrained by high energy and food costs, as the downward correction in energy prices is reflected with some delays in the actual payment of bills while food prices were still elevated. Tourism continued to perform strongly, and some positive signs were observed in the construction and automobile sectors. In addition, the recovery in Portugal's water reservoirs after the severe drought until September 2022 had a positive impact on the country's power generation and energy trade balance, as hydropower plays an important role in the domestic electricity sector. Overall, taking into account the reported flash GDP estimate of 1.6% (q-o-q) in 2023-Q1, full-year GDP growth is projected at 2.4% in 2023 and 1.8% in 2024, according to the Commission 2023 spring forecast. In 2023, growth is mainly supported by the ongoing expansion in tourism and government consumption while private consumption and investment are expected to be key growth drivers in 2024.

The balance of risks to Portugal's growth outlook remains on the downside. This reflects significant global risks and uncertainty as well as rising interest rates across Europe in the context of high inflation that triggered monetary policy normalisation. Previous country-specific risks related to the drought have abated with the recovery in the water reservoirs. In addition, the impact of higher interest rates on investments is partly offset by the large number of projects benefiting from EU funding.

The current account deficit expectedly deteriorated in 2022 but is set to improve substantially in 2023. The current account deficit widened moderately from 0.8% of GDP in 2021 to 1.3% in 2022. In both years, the deficit was fuelled by temporary factors, related mainly to travel restrictions in 2021 and price effects in 2022. In 2022, tourism revenues recovered substantially in real terms and in nominal terms exceeded the pre-pandemic level, as net travel receipts reached an all-time high of 6.5% of GDP. However, the country's overall trade balance faced a very substantial negative impact from high energy prices in 2022, leading to an overall deterioration in the terms of trade of 3.3%. A simulation with neutral terms of trade shows that the current account would have posted a surplus of 0.3% of GDP. This is also illustrated by the positive trade

dynamics in real terms where exports of services surged by 42.8% in 2022 and overall net exports of goods and services had a net contribution of two percentage points to GDP growth. As energy prices dropped substantially and supply bottlenecks have largely faded away towards the end of 2022 and in early 2023, the current account is set to improve substantially, helped also by the favourable outlook in tourism.

Graph 2.2: **Current account balance**



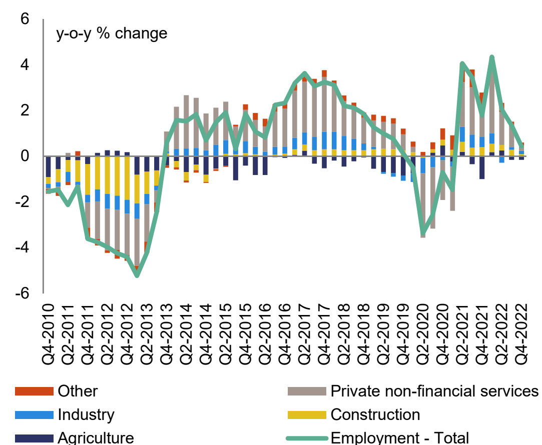
Source: Banco de Portugal.

Portugal's net international investment position (NIIP) improved substantially for a second year in a row in 2022. The NIIP share in GDP increased from -104.6% of GDP at the end of 2020 to -95.0% at the end of 2021 and -83.9% at the end of 2022. A substantial part of this improvement resulted from the strong rebound in GDP and favourable valuation changes while the overall net flow in the current and capital accounts was slightly negative. The outlook for the NIIP remains favourable considering the expected improvement in the current account balance and nominal GDP.

Unemployment increased in late 2022 and early 2023 due to higher activity rates. In annual average terms, unemployment improved from 6.6% in 2021 to 6.0% in 2022. However, the monthly figures show a strong increase to 6.7% at the end of 2022 and 7.0% in January 2023, followed by some reduction to 6.8% in February 2023. The increase in unemployment was exclusively driven by higher job-seeking activity, helped by positive net migration flows and activation of individuals who had been outside the labour force.

Employment continued growing, however at a slowing pace of 0.6% (y-o-y) in February 2023, while the labour force grew at a faster pace of 1.9% for the same period. Both the employment rate and the share of the labour force in the working age population reached historic highs. Employment in 2022 was 2.8% above the pre-pandemic level in 2019 while total hours worked fell by 3%. Over the same period, labour productivity improved only marginally in terms of GDP per employee, but more significantly in terms of GDP per workhour. Across main sectors, employment in tourism increased substantially in 2022 but remained well below the pre-pandemic level in 2019. At the same time, employment rose substantially above pre-pandemic levels in the information and communications sector and to a somewhat lesser extent in the sectors of healthcare, public administration, education, professional and scientific services, and education.

Graph 2.3: **Employment evolution by sectors**



Source: Eurostat.

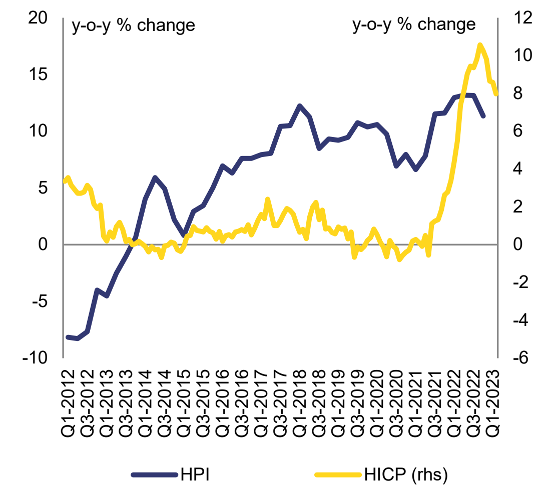
Employment is expected to grow at a relatively slow pace in the short term. In light of the GDP projection in 2023, employment growth is set to remain subdued during the year. Job creation could be constrained by the potential of companies to boost production by additional hours worked, instead of hiring new employees. At the same time, the strong performance in tourism is set to further support employment in the short term. Accordingly, unemployment is expected to

gradually decrease from the peak of 7.0% in January 2023 while the recently observed increase in the activity rate is set to moderate.

Inflation is moderating after reaching a record high in 2022. HICP inflation decreased to 8.4% (y-o-y) in 2023-Q1 after having reached a historic high of 10.2% in the previous quarter. The reduction was largely driven by the drop in energy price inflation to 1.4% in 2023-Q1 relative to 24.3% in the previous quarter. This also triggered some deceleration in the group of non-energy industrial goods while growth in service prices remained relatively stable at high levels. However, the growth rate in prices of both processed and unprocessed food products edged up to 17.1% and 20.7%, respectively, turning the food market into a major inflationary driver. Core inflation, defined as the headline HICP index excluding energy and unprocessed food, remained relatively stable at around 8% in 2023-Q1.

Inflation is set to moderate further in 2023, helped by the recent drop in commodity prices. In light of the recent drop in commodity prices, particularly of energy and some agricultural goods, HICP inflation is expected to continue declining in 2023. Country-specific factors related to the severe drought until September 2022 are not expected to drive inflation anymore, as the water reservoirs recovered to high levels as of March 2023. Nevertheless, the latest price readings show that food prices are reacting slowly to the changes in prices of energy and agricultural commodities and their disinflationary impact is likely to be more significant only in the second half of 2023 and in early 2024. At the same time, core inflation is projected to move above the headline inflation as of 2023-Q2, as the current wage pressures in the context of record high employment rates and the strong recovery in foreign tourism are expected to keep service prices elevated.

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



Source: Eurostat.

House prices grew 12.6% in 2022. House price growth picked up from 9.4% in 2021 to 12.6% in 2022. However, the increase in the deflated house price index, adjusted for the private consumption deflator, slowed down from 7.9% in 2021 to 5.9% in 2022. In quarterly terms, the nominal house price growth rate moderated to 11.3% (y-o-y) in 2022-Q4 after having reached a peak of 13.2% in 2022-Q2. The deflated index slowed more substantially to 2.1% (y-o-y) in 2022-Q4 from 6.8% in 2022-Q2 and 6.4% in 2022-Q3. The observed increase in the mortgage interest rates contributed to the moderation in the house price growth towards the end of the year but tight property supply as well as higher construction costs and demand by foreign investors maintained the price pressure on the market. With the expected further increase in interest rates, house prices are projected to grow at a much slower pace while a strong correction in price levels is not expected at this stage, considering the limited volumes of new construction.

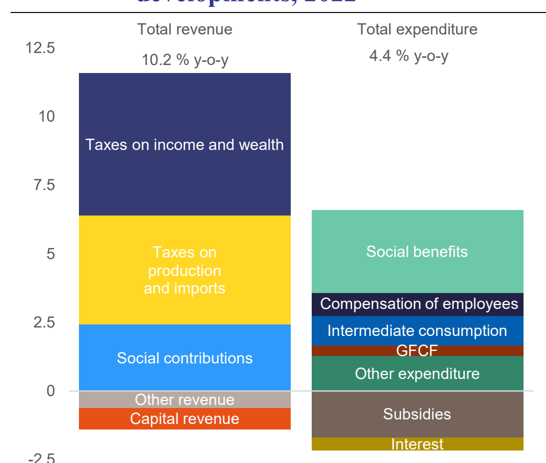
3. PUBLIC FINANCE DEVELOPMENTS

3.1. FISCAL PERFORMANCE AND OUTLOOK

Portugal's public deficit improved significantly in 2022, outperforming government's plans. Portugal's public deficit reached 0.4% of GDP in 2022, compared with 2.9% of GDP in 2021, and well below the 1.9% of GDP projected in the Portuguese 2023 State Budget. Government revenues increased by 10.2% y-o-y in 2022 (see Graph 3.1), benefiting from the strong economic rebound, resilient labour market and high inflation. Taxes on income and wealth were the main contributors to this increase (5.2 pps.), stemming mainly from corporate income tax revenues, followed by taxes on production and imports (4.0 pps.), due to a large extent to the behaviour of VAT revenues, and social contributions (2.4 pps.). Expenditure increased by 4.4% y-o-y in 2022 (see Graph 3.1). While the continued phase-out of COVID-19-related measures contributed to curb expenditure, upward pressures on current spending persisted. Social benefits weighed on expenditure (3.0 pps.), partly reflecting the fiscal policy response to the exceptional increase in energy price inflation. Compensation of employees continued on an upward trajectory (0.8 pps.), with a higher number of civil servants, as well as intermediate consumption (1.1 pps.). Other expenditure also contributed positively (1.3 pps.), reflecting the support to public corporations such as TAP Air Portugal and SATA Air Açores. Public investment continued to contribute positively to expenditure (0.4 pps.), below the estimates in the Portuguese 2023 State Budget. These developments more than compensated the negative contribution from interest expenditures (0.5 pps) and subsidies (1.7 pps) to expenditure's annual growth.

Portugal's public debt-to-GDP ratio contracted considerably in 2022. The Portuguese public debt-to-GDP ratio declined by 11.5 pps of GDP as compared with 2021, to 113.9% in 2022, already below pre-pandemic levels. This decrease mostly reflects the favourable snowball effect (10.9 pps. of GDP), which translates the differential between the average interest rate and nominal GDP growth. While real GDP growth in 2022 was strong, public debt-to-GDP ratio developments importantly benefited from the higher inflation and thus a higher GDP deflator (also known as denominator effect). At the same time, interest expenditure decreased in 2022 as a share of GDP. This is coupled with a debt-reducing primary balance effect (1.6 pps of GDP). On the other side, the debt-increasing stock-flow adjustment (reflecting the difference between the change in debt and deficit) amounted to 1.0 pps of GDP in 2022.

Graph 3.1: **Revenue and expenditure developments, 2022**



(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 Ministry of Finance.

Under a no-policy-change assumption, Portugal's public finances are projected to improve. According to the 2023 Commission spring forecast, which incorporates the information available in the Portuguese 2023-2027 Stability Programme, Portugal's public deficit is projected to narrow to 0.1% of GDP in 2023, mainly due to the buoyant government revenue growth still reflecting the sustained elevated prices, and it is forecast to remain unchanged in 2024. The Portuguese public debt-to-GDP ratio is expected to continue on a downward path, declining to 106.2% in 2023 and 103.1% in 2024. This outlook compares with that of Portugal's 2023-2027 Stability Programme, where the public deficit and the public debt-to-GDP ratio are forecast to reach 0.4% of GDP and 107.5%, respectively, in 2023 and 0.2% of GDP and 103.0% in 2024.

However, Portugal's public finances face different challenges. Country-specific challenges include the contingent liabilities linked to publicly guaranteed credit lines, ongoing processes on public-private partnerships (PPPs) financial rebalancing requests, including those related to the impact of COVID-19 on their activity, vulnerabilities in some public corporations, and the persistent upward pressure on current expenditure, in particular on the public wage bill and challenges emerging from higher inflation and demographic ageing.

3.2. POLICY ISSUES

Key fiscal-structural reforms are yet to be implemented. Priority should be given to fiscal-structural reforms enhancing the quality and composition of Portugal's public finances, while strengthening their resilience and contributing to their medium- and long-term sustainability. Reforms in these areas include improving the effectiveness of the tax and social protection systems ([4]), in particular by simplifying both frameworks, strengthening the efficiency of their respective administration, and reducing the associated administrative burden. Delivering on the full and effective implementation of the 2015 Budgetary Framework Law is critical, as provided for by the Portuguese recovery and resilience plan (RRP). Steps have been undertaken to implement spending reviews in the budgetary process. These notably include the setting up of a taskforce within the Ministry of Finance, in cooperation with relevant international institutions.

The financial situation of the National Health Service (NHS) is slowly recovering, on the back of increasing allocations from the State Budget. The NHS balance was hard-hit by the outbreak of the COVID-19 pandemic, recording a deficit of 0.6% of GDP in 2021. Preliminary data points to a reduction of the deficit to 0.4% of GDP in 2022. These balance developments are influenced by increased transfers from the State budget, amounting to 4.8% of GDP in 2022 and planned to increase in 2023, according to the Portuguese 2023 State Budget. NHS financial arrears decreased by the end of 2022, due to the coverage granted by the additional State budget transfers. However, upward pressures on NHS spending on wages, medicines and medical services, persist. According to the Portuguese authorities, initiatives are being undertaken to strengthen the NHS's governance, with efforts in place for the systematic approval of annual budget activity plans ([5]). In terms of reforms and investment, the Portuguese RRP includes measures to address several challenges faced by the NHS, strengthening its response capacity, overall expenditure control, cost efficiency and adequate budgeting. In this context, in July 2022 a new management contract template for state-owned enterprises (SOEs) operating in the NHS entered into force ([6]). In addition, legislation entered into force in March 2022 underpinning the provision of financial support by Regional Health Authorities to promoters from the public, social and private sectors ([7]).

The SOEs sector improved its financial performance in 2022, but vulnerabilities remain. In 2022, SOEs in overall improved their financial performance, with increased turnover and net income, propelled by the recovery of economic activity. However, higher prices weighed on SOEs operational expenditure. The debt-to-GDP ratio of public non-financial corporations decreased to 9.7% in 2022, down from 10.4% in 2021. A total of 0.5% of GDP in capital injections were allocated to public corporations in 2022, including to TAP Air Portugal S.A., SATA Air Açores and FINOVA ('*Fundo de Apoio ao Financiamento à Inovação*'). Liquidations and mergers took place in 2022, the latter potentially leading to efficiency gains. PPPs net payments are expected to follow a downward trend going forward. Financial

([4]) Council Recommendation of 12 July 2022 on the 2022 National Reform Programme of Portugal and delivering a Council opinion on the 2022 Stability Programme of Portugal, OJ C 334, 1.9.2022, p. 181–189.

([5]) Decree-Law No 52/2022 of 4 August published in the Portuguese Official Journal ('*Diário da República*'), No 150/2022, first supplement, first series of 4 August 2022, pages 5-52
Decree-Law No 61/2022 of 23 September published in the Portuguese Official Journal ('*Diário da República*'), No 155/2022, first supplement, first series of 23 September 2022, pages 2-21

([6]) Government Order No 167-B/2022 of 30 June published in the Portuguese Official Journal ('*Diário da República*'), No 125/2022, first supplement, first series of 30 June 2022, pages 10-24

([7]) Government Order No 134-A/2022 of 30 March published in the Portuguese Official Journal ('*Diário da República*'), No 63/2022, first supplement, first series of 30 March 2022, pages 2-15.

rebalancing requests related to the impact of COVID-19 on PPPs, mostly from those operating in the transport and health sector, are under assessment.

Portugal adopted measures to cushion the impact of energy price inflation on households and firms. These measures include lump-sum payments to low-income households disbursed in three instalments (April, July and December) in 2022, extended to quarterly lump-sum payments in 2023, a one-time payment to adults and children, and an exceptional supplement for pensioners both carried out in October 2022. With the objective to reduce the electricity grid tariffs, borne by all consumers, Portugal allocated a total of EUR 650 million (0.3% of GDP) to the national electricity system in 2022. A total of EUR 1 billion (0.4% of GDP) was allocated to the national gas system to support a transitional regime for the stabilisation of gas prices paid by firms throughout 2023 ([8]). Related tax policy measures mainly consist of the reduction of the fuel tax, the suspension of the increase in the carbon tax and a reduction of the VAT for electricity. According to the Commission 2023 spring forecast, the net budgetary cost of this set of measures amounted to 2.0% in 2022, and it is estimated at 0.8% of GDP in 2023 ([9]).

The Portuguese government recently announced a new set of fiscal policy measures. In February 2023 the Portuguese government approved a draft programme ('*Mais Habitação*'), with a draft Law proposal pending discussion and approval in the Portuguese Parliament, targeting the Portuguese housing market. The programme includes a set of tax policy measures, such as tax exemptions from the immovable property tax and the personal income tax, aimed at boosting housing supply. An income support for rents and a relief for the interest payments arising from housing loans was already introduced in March 2023 ([10]). Measures were also adopted with the purpose of mitigating the impact of inflation on households' purchasing power. These notably include a VAT exemption for a selected basket of goods which are deemed to be essential, in force from April to October 2023 ([11]), and permanent increases in civil servants' remunerations and pensions. The budgetary impact of these measures is estimated at approximately 0.6% of GDP in 2023.

([8]) Decree-Law No 84-B/2022 of 9 December published in the Portuguese Official Journal ('*Diário da República*'), No 236/2022, second supplement, first series of 9 December 2022, pages 66-69.

([9]) The 2023 Country Report for Portugal includes a box that provides a comprehensive overview of the measures taken in response to the energy crisis, together with an assessment of whether they are targeted towards the most vulnerable and preserve the price signal, as well as the government's intentions for their withdrawal.

([10]) Decree-Law No 20-B/2023 of 22 March published in the Portuguese Official Journal ('*Diário da República*'), No 58/2023, first supplement, first series of 22 March 2023, pages 32-40.

([11]) Law No 17/2023 of 14 April published in the Portuguese Official Journal ('*Diário da República*'), No 74/2023, first supplement, first series of 14 April 2023, pages 2-4.

4. FINANCIAL SECTOR DEVELOPMENTS

The banking sector remains resilient amid high global uncertainty. Geopolitical tensions continue to fuel uncertainty whereas the normalisation of monetary policy is slowly filtering through the real economy and banks' balance sheets. However, the banking sector appears overall resilient. There are still vulnerabilities related to the high indebtedness of some economic agents, and some lenders continue to be heavily exposed to asset classes with high sensitivities to interest rates increases, namely real estate assets and fixed income securities. The banking sector's exposure to market and credit risks highlights the importance of adequately evaluating customers' capacity to repay. Real estate prices have continued to increase over the past months, and the credit profile of borrowers grew increasingly robust thanks to Banco de Portugal's macroprudential recommendations, whereas the government borrowers' support measures provide an additional safety net. Banks are also required to monitor debt-servicing ratios and provide restructuring solutions. Households' indebtedness ratio has also decreased over the past decade and the accumulation of deposits during the pandemic has generally lifted the resilience of both households and non-financial corporations (NFC).

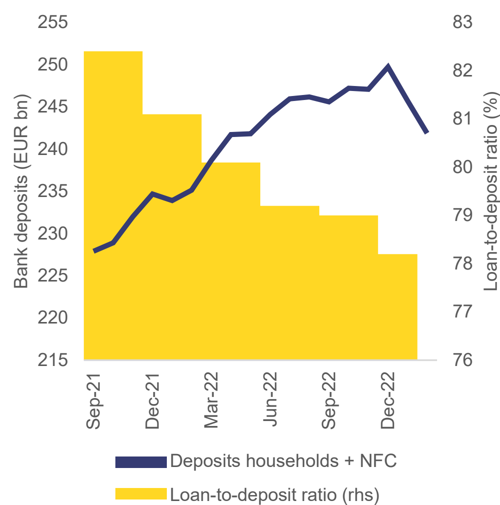
Net interest income has boosted 2022 profits. Portuguese banks reported positive developments across key profitability components. The rising Euribor translated into higher interest income on banks' predominant variable-rate loans and on their placements with the ECB. Interest expenses on deposits did not increase at the same pace, given banks' ample liquidity reserves. The repricing of large positions in fixed income instruments has also remained manageable. Banks in aggregate also improved their cost-efficiency ratio (cost-to-core-income dropped from 58.5% at end-2021 to 54.5% end-2022) as operational costs increased only moderately compared to income levels. New loan impairments were low and asset quality remained resilient. The decline in the build-up of provisions and impairments was also supported by a better-than-expected domestic economic environment. These developments pushed up banks' return on assets (ROA) to 0.7% at end-2022, 23 basis points higher year-over-year and at its highest level since the financial crisis. Return on equity (ROE) also improved, and at end-2022 stood at 8.8%, 3.4 percentage points (pps.) above the figures of end-2021. Going forward, the financial performance of Portuguese banks will remain strongly contingent upon the trajectory of interest rates on loans, placements with the ECB and banks' liabilities (deposits and debt instruments), as well as upon developments in credit quality.

The supply of new credit continues to decelerate as financing conditions are becoming tighter. In February 2023, the annual rate of change of loan stocks had declined for both NFCs and households, to -0.3% and 2.2%, respectively. Private NFC indebtedness in Portugal decreased slightly in the second half of 2022, in line with the evolution of the Portuguese economy. Both supply and demand factors seem to affect these recent lending developments. The latest Bank Lending Survey (January 2023) hints towards banks tightening credit standards for SMEs and households (for house purchase), as a consequence of the slowdown in economic activity over the past months. Firms and households also seem to be less inclined to borrow as lending is becoming more expensive. Portuguese banks have adjusted their retail and corporate bank interest rates to increases in market rates faster than the euro area average: in February the interest rate on new mortgage loans increased to 3.52%, from 1.47% in June 2022, compared to the euro area average of 3.26% and the interest rate on new loans below EUR 1 million to corporations increased to 5.15% from 2.27%, above the euro area figure of 4.26%. As a result of the reduced lending activity, among other reasons, non-consolidated debt-to-GDP ratios continued to decrease for both NFC (from 127% to 121%) and households (from 66% to 64%) over that timeframe and remained below euro area averages.

Banks continued to reduce their NPLs through write-offs and sales. Banks reduced their NPL ratio from 3.7% at end-2021 to 3.0% at end-2022. Defaults and insolvencies remained low and NPL sales in the secondary market also contributed to this reduction. These improvements were spread across portfolios, and over 2022 the NPL ratio declined for both households (2.8% to 2.3%), and NFC (8.1% to 6.5%). The sectors that were most affected by the pandemic still display a higher concentration of NPLs but reported marked improvements in 2022, as their NPL ratio decreased by more than 3 pps. The NPL coverage

ratio also improved, from 52.5% at end-2021 to 55.4% at end-2022. Going forward, possible delayed waves of insolvencies warrant caution. It will remain paramount for both banks and supervisors to timely identify deteriorating credit quality and pockets of risks.

Graph 4.1: **Deposits to Households and NFC – Loan to deposit ratio**



Source: Banco de Portugal.

Portuguese banks' capital and liquidity positions remained sound, despite a recent shift of deposits to government instruments. Credit institutions' CET1 ratio further improved to 15.3% by end-2022 (from 15% in Q2-2022), by virtue of a considerable assets' decrease and, partly, of an increase in their own funds. Capital ratios thus remain solid and well above the regulatory requirements. Similarly, at 229% the Liquidity Coverage Ratio (LCR) comfortably continues to outperform the LCR of euro area peers, despite a decline (-33 pps.) over the second half of 2022. The loan-to-deposit ratio of Portuguese banks dropped to historically low levels by end-2022 (78.2%), well below the euro area average, despite a drop in clients' deposits over the same period. Clients' deposits have been shrinking since Q2-2022 and fell by 2.1% between October 2022 and February 2023. Portuguese households are increasingly moving their savings from banks' savings accounts, offering no or little remuneration, to other financial products. One of these substitutes for deposits are the government's saving certificates (see Section 5), which increased by 71% in outstanding volumes underwritten between September 2022 and February 2023. While stronger competition among banks for deposits seems unlikely in the near term, the recent shift to government certificates may put some pressure on banks to increase deposit rates, and if volatility in wholesale funding markets persists, the issuance of Minimum Required Eligible Liabilities (MREL) could become more expensive.

Inflation may affect the debt-servicing capacity of the private sector. Higher interest rates are gradually increasing the debt burden on households and inflation is eroding their purchasing power. As a result, the share of vulnerable households, with higher loan service-to-income ratios, is estimated to have risen in 2022 and early 2023. Until now, insolvency rates in Portugal have been very low, but some vulnerabilities have been building up in the sectors most affected by the pandemic. SMEs, usually with lower pricing power than bigger firms, may also find it more difficult to pass on price increases to customers. However, as previously mentioned, new borrowers' risk profile has improved markedly as a result of the macroprudential recommendation by Banco de Portugal. Moreover, mortgage loan renegotiations to mitigate the negative impact of inflation on borrowers' repayment capacity have started picking up. They accounted for 32% of new property loans in January 2023, compared to 7% in 2022. Lastly, the recently adopted mortgage support scheme (see Chapter 3) will help vulnerable homeowners who struggle to pay back their mortgages.

Table 4.1: **Financial stability indicators**

in %	Portugal									Euro area	EU
	Q4-2016	Q4-2017	Q4-2018	Q4-2019	Q4-2020	Q4-2021	Q1-2022	Q2-2022	Q3-2022	Q3-2022	Q3-2022
Non-performing loans	17.2	13.3	9.4	6.1	4.9	3.6	3.6	3.4	3.2	1.8	1.8
o/w NFC sector	29.4	25.2	18.5	12.3	9.8	8.1	8.0	7.6	7.2	3.4	3.3
o/w HH sector	8.7	7.1	5.1	3.7	3.4	2.8	2.7	2.6	2.5	2.1	2.2
Coverage ratio	45.4	49.9	52.4	51.7	55.4	52.6	53.5	52.8	53.7	45.6	45.5
Return on equity(1)	-5.5	-0.8	2.7	4.3	0.0	4.9	8.5	8.6	8.2	6.1	6.1
Return on assets(1)	-0.3	0.0	0.3	0.5	0.0	0.4	0.7	0.7	0.6	0.4	0.4
Total capital ratio	12.3	15.2	15.2	16.7	18.1	18.0	17.5	17.5	17.2	18.5	18.6
CET 1 ratio	11.4	13.9	13.2	14.1	15.4	15.5	14.9	15.0	14.6	15.1	15.3
Tier 1 ratio	11.7	14.5	13.9	15.2	16.6	16.3	15.7	15.8	15.4	16.2	16.3
Loan to deposit ratio	80.8	78.9	76.2	76.4	72.1	68.9	68.4	68.0	78.9	85.9	88.6

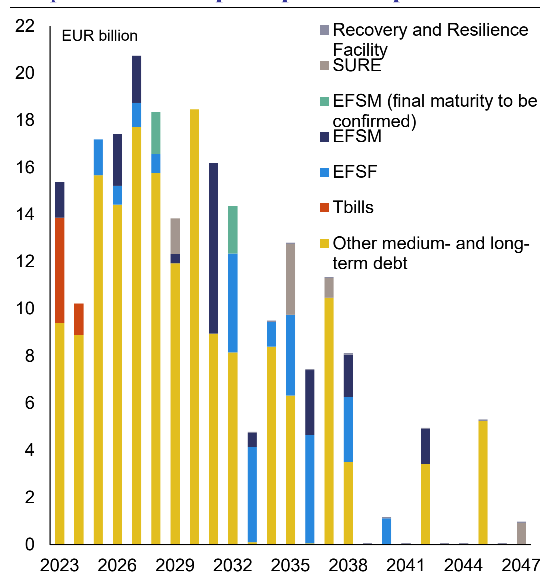
(1) Annualised data.
Source: Source: ECB - CBD2 - Consolidated Banking data; own calculations.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Portugal's financing needs started to decrease albeit still remaining above pre-pandemic levels. Financing needs reached EUR 24.9 billion (10.4% of GDP) in 2022, already below the peak of EUR 26.6 billion (12.4% of GDP) recorded in 2021. The lower financing needs reflect the improvement in the budget balance and reduced net acquisition of financial assets. These more than compensated the year's redemptions, including the EUR 0.5 billion repayment to the European Financial Stability Mechanism (EFSM) executed on 4 April 2022 ([12]). Financing needs are projected to remain broadly unchanged in 2023, at EUR 24.8 billion (9.6% of GDP). The higher net acquisition of financial assets in 2023 offsets the lower debt redemptions (already accounting for the EUR 1.5 billion repayment to the EFSM) and the projected improvement of the headline deficit on a cash basis.

Retail debt is gaining importance as a financing source. Retail debt instruments such as the so-called saving certificates ('*Certificados de Aforro*') ([13]) have become increasingly attractive for Portuguese households. The net issuance of retail debt instruments is projected at EUR 12 billion in 2023, compared to around EUR 0.5 billion in 2021. Traditional financing sources, such as Portuguese government bonds ([14]) or T-bills, are expected to lose weight compared to Portugal's initial financing programme for 2023. The use of deposits is planned to remain a marginal source of funding in 2023. Portugal's cash buffer was EUR 13.9 billion by the end of 2022 (5.8% of GDP), EUR 1.6 billion less than in 2021 and below pre-pandemic levels. It is expected to remain stable in 2023 at EUR 13.6 billion (5.2% of GDP), covering one-third of the year's financing needs.

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



(1) Last update: 12-04-2023.
Source: Portuguese Treasury and Debt Agency (IGCP).

Active debt management seeks to smoothen the debt redemption profile (see Graph 5.1). In 2022, Portugal continued to engage in operations, such as debt buy-back transactions and bond issuances targeting longer maturities, aimed at managing refinancing risks, lengthening the average debt maturity, and containing interest expenditures. During the first quarter of 2023, buy-backs of Portuguese government bonds, otherwise maturing in 2023 and 2024, amounted approximately to EUR 2 billion. The average residual maturity of Portugal's public debt was about eight years in 2022, and it is expected to go down by one year in 2023. Portuguese government bonds remain the country's main funding instrument, with syndications and auctions being the main issuance methods. The investors' base remains stable and diversified across regions and types. Private investors are expected to become net buyers of Portuguese government bonds in 2023, following the ECB's ending of net purchases under the asset purchase programme (APP).

Portugal benefits from EU-financing sources. Under the Recovery and Resilience Facility (RRF),

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

([13]) Saving certificates ('*Certificados de Aforro, série E*') are non-tradable and retail distributed, only to be subscribed by households. With a maturity of 10 years, their interest rate is calculated on a monthly basis considering the three-month Euribor rate. Their interest rate can fluctuate between 0% to 3.5%, being accrued on a quarterly basis. Early redemptions, total or partial, are possible (Government Order No 329-A/2017 of 30 October). The interest rate for subscriptions and capitalisation of saving certificates ('*séries E*') was fixed at 3.5% in April 2023.

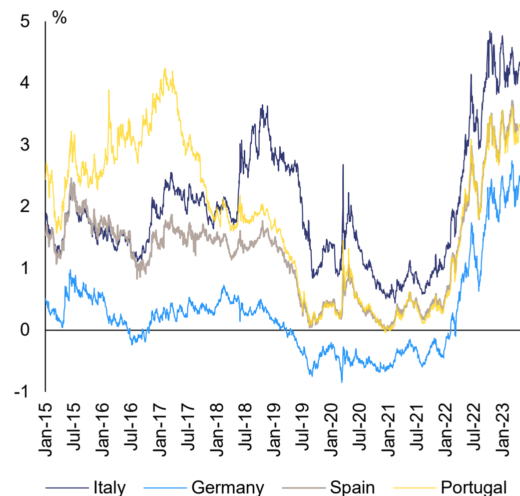
([14]) Portuguese government bonds issuances for 2023 include the private placement of bonds to *Caixa Geral de Aposentações* (CGA) as part of the transfer of liabilities from the *Fundo de Pensões do Pessoal da Caixa Geral de Depósitos* (FPCGD) to CGA (Decree-Law No 14/2023 of 24 February).

which supports financially the Portuguese recovery and resilience plan (RRP) ([15]), a total of EUR 1.16 billion (0.5% of GDP) – of which, EUR 0.55 billion in grants and EUR 0.61 in loans – was disbursed to Portugal in 2022 ([16]). On 8 February 2023 Portugal received an additional EUR 1.8 billion (0.7% of GDP) – of which, EUR 1.7 billion in grants and EUR 0.1 billion in loans ([17]). The total maximum amount of the Support to mitigate Unemployment Risks in an Emergency (SURE) loan has already been fully disbursed to Portugal, of which EUR 3 billion on 1 December 2020, EUR 2.4 billion on 25 May 2021, EUR 0.5 billion on 29 March 2022 and EUR 0.3 billion on 14 December 2022.

Portugal enjoys a favourable market access. In December 2021, the ECB started a path of monetary policy normalisation ([18]). Since then, it has raised its main policy rates by 3.5 percentage points. Following increases since March 2022 reflecting the tightening of financing conditions, the 10-year Portuguese government bonds yields stood at 3.3% at the end of April 2023, (see Graph 5.2). Spreads against the German bund benchmark have remained broadly stable, trading below Portugal's main euro area peers. The Portuguese public debt is classified with an 'investment' grade by the four major rating agencies. On 27 January 2023 DBRS confirmed Portugal's rating of 'A (low)' with a 'stable' trend. Standard and Poor's confirmed Portugal's rating of 'BBB+' and 'stable' trend on 10 March 2023, followed by Fitch which on 14 April 2023 also affirmed Portugal's rating of 'BBB+' and 'stable' trend.

Portugal's public debt-to-GDP ratio is expected to continue decreasing but is vulnerable to shocks. The Portuguese public debt-to-GDP ratio recorded 113.9% in 2022, down from 125.4% in 2021, and already reaching levels close to 2011. The public debt-to-GDP ratio is projected to further contract to 106.2% and 103.1% in 2023 and 2024, respectively (see Section 3). The implicit interest rate on Portugal's public debt continued its declining trend to 1.7% in 2022, 0.2 pps below 2021. According to the 2023 Commission spring forecast, this declining trend is expected to be reversed as of 2023 (see Table 7 in Annex 1). According to the Commission's debt sustainability analysis (see Annex 2), medium-term risks to Portugal's fiscal sustainability are high overall, with public debt-to-GDP developments being vulnerable to a worsening of economic and financing conditions.

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



Source: European Commission.

Portugal retains the capacity to service its debt. Financial assistance loans were fully repaid to the IMF by December 2018. The outstanding debt to the European Financial Stability Facility (EFSF) and EFSM amounts to EUR 25.3 billion and EUR 23.8 billion, respectively. An EFSM maturity of EUR 1.5 billion is scheduled for the end of 2023, with the next EFSF loan repayment of EUR 1.5 billion scheduled in 2025 (see Graph 5.1). 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 it with fixed

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

([16]) Positive preliminary assessment of the satisfactory fulfilment of milestones and targets related to the first payment request submitted by Portugal on 25 January 2022, transmitted to the Economic and Financial Committee by the European Commission.

([17]) Positive preliminary assessment of the satisfactory fulfilment of milestones and targets related to the second payment request submitted by Portugal on 30 September 2022, transmitted to the Economic and Financial Committee by the European Commission

([18]) This process began with the ECB's announcement that the net asset purchases under the pandemic emergency purchase programme (PEPP) would end in the first quarter of 2022. Subsequently, the ECB also ended the net purchases under the asset purchase programme (APP) and increased its main policy rates

rates, stable financing sources and its debt currency denomination. In the medium to long term, fiscal policies aimed at ensuring a prudent fiscal position while raising potential growth, alongside adequate fiscal-structural reforms, remain important to strengthen the resilience of Portugal's fiscal sustainability and its capacity to repay.

ANNEX 1
Main macroeconomic and financial indicators

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

Annual % change	**2021**	**2022**	**2023**	**2024**
1. Private consumption expenditure	4.7	5.8	0.5	1.5
2. Government consumption expenditure	4.6	1.7	2.7	1.3
3. Gross fixed capital formation	8.7	3.0	2.9	3.6
4. Final domestic demand	**5.4**	**4.5**	**1.4**	**1.9**
5. Change in inventories	--	--	--	--
6. Domestic demand	**5.6**	**4.5**	**1.4**	**1.9**
7. Exports of goods and services	-18.6	16.7	5.4	3.2
7a. - of which goods	10.7	5.1	2.7	3.2
7b. - of which services	20.1	42.8	10.1	3.1
8. Final demand	**7.7**	**8.0**	**2.7**	**2.3**
9. Imports of goods and services	13.2	11.1	3.3	3.6
9a. - of which goods	12.7	9.6	3.1	3.6
9b. - of which services	15.9	18.5	4.5	3.6
10. Gross domestic product at market prices	**5.5**	**6.7**	**2.4**	**1.8**
Contribution to change in GDP				
11. Final domestic demand	5.5	4.6	1.4	1.9
12. Change in inventories + net acq. of valuables	0.3	0.0	0.0	0.0
13. External balance of goods and services	-2.9	2.0	1.0	-0.2

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

Annual % change	**2021**	**2022**	**2023**	**2024**
1. Private consumption expenditure	6.1	12.5	4.8	4.2
2. Government consumption expenditure	6.1	5.9	8.2	2.5
3. Gross fixed capital formation	13.2	11.3	5.9	5.8
4. Final domestic demand	**7.4**	**11.0**	**5.6**	**4.2**
5. Change in inventories	--	--	--	--
6. Domestic demand	**7.8**	**11.1**	**5.6**	**4.2**
7. Exports of goods and services	20.4	33.9	7.5	4.9
8. Final demand	**11.2**	**17.7**	**6.2**	**4.4**
9. Imports of goods and services	21.6	31.7	2.2	5.1
10. Gross national income at market prices	7.7	11.0	8.4	4.1
11. Gross value added at basic prices	6.3	11.2	8.6	3.7
12. Gross domestic product at market prices	**7.1**	**11.4**	**8.4**	**4.1**
Nominal GDP, EUR bn	214.7	239.3	259.3	270.0

Table 3: Implicit price deflators

% change in implicit price deflator	2021	2022	2023	2024
1. Private consumption expenditure	1.4	6.3	4.3	2.6
2. Government consumption expenditure	1.4	4.1	5.4	1.2
3. Gross fixed capital formation	4.1	8.1	2.9	2.1
4. Domestic demand (incl. inventories)	**2.1**	**6.3**	**4.2**	**2.3**
5. Exports of goods and services	6.0	14.8	2.0	1.7
6. Final demand	**3.2**	**8.9**	**3.5**	**2.1**
7. Imports of goods and services	7.3	18.5	-1.1	1.5
8. Gross domestic product at market prices	**1.5**	**4.4**	**5.8**	**2.3**
HICP	**0.9**	**8.1**	**5.1**	**2.7**

Table 4: Labour market and cost

Annual % change	2021	2022	2023	2024
1. Labour productivity (real GDP per employee)	3.5	4.6	1.9	1.1
2. Compensation of employees per head	4.1	6.1	5.7	2.9
3. Unit labour costs	**0.6**	**1.5**	**3.7**	**1.7**
4. Total population	-0.1	-0.1	0.1	0.1
5. Population of working age (15-74 years)	0.2	-0.3	0.1	0.1
6. Total employment	1.9	2.1	0.5	0.6
7. Calculated unemployment rate - Eurostat definition	**6.6**	**6.0**	**6.5**	**6.3**

Table 5: External balance

levels, EUR bn	2019	2020	2021	2022
1. Exports of goods (fob)	62.1	75.8	78.0	81.5
2. Imports of goods (fob)	78.6	103.2	103.8	108.8
3. Trade balance (goods, fob/fob) (1-2)	**-16.6**	**-27.4**	**-25.8**	**-27.3**
3a. p.m. (3) as % of GDP	***-7.7***	***-11.4***	***-9.9***	***-10.1***
4. Exports of services	27.3	43.9	50.8	53.6
5. Imports of services	16.9	22.6	24.8	26.3
6. Services balance (4-5)	**10.4**	**21.3**	**25.9**	**27.3**
6a. p.m. 6 as % of GDP	***4.9***	***8.9***	***10.0***	***10.1***
7. External balance of goods & services (3+6)	**-6.1**	**-6.1**	**0.2**	**0.0**
7a. p.m. 7 as % of GDP	***-2.9***	***-2.5***	***0.1***	***0.0***
8. Balance of primary incomes and current transfers	4.4	2.6	2.5	2.3
8a. - of which, balance of primary income	-2.2	-3.4	-3.6	-3.9
8b. - of which, net current Transfers	6.5	6.0	6.1	6.2
8c. p.m. 8 as % of GDP	2.0	1.1	0.9	0.8
9. Current external balance (7+8)	**-1.8**	**-3.5**	**2.6**	**2.2**
9a. p.m. 9 as % of GDP	***-0.8***	***-1.5***	***1.0***	***0.8***
10. Net capital transactions	3.7	2.1	2.6	2.6
11. Net lending (+)/ net borrowing (-) (9+10)	**1.9**	**-1.4**	**5.2**	**4.8**
11a. p.m. 11 as % of GDP	***0.9***	***-0.6***	***2.0***	***1.8***

Table 6: Fiscal accounts

	2021	2022	2023	2024
% of GDP				
Taxes on production and imports	15.1	15.1	14.9	15.3
Current taxes on income, wealth, etc.	9.6	10.7	10.5	10.2
Social contributions	12.7	12.4	12.1	12.0
Sales and other current revenue	6.2	5.4	5.6	5.3
Total current revenue	**43.7**	**43.6**	**43.0**	**42.8**
Capital transfers received	1.2	0.8	1.4	1.4
Total revenue	**44.9**	**44.4**	**44.4**	**44.2**
Compensation of employees	11.6	10.8	10.8	10.7
Intermediate consumption	5.8	5.7	6.0	5.9
Social transfers in kind via market producers	2.0	2.0	1.9	1.9
Social transfers other than in kind	17.4	16.7	15.9	16.0
Social payments	19.4	18.7	17.8	18.0
Interest paid	2.4	2.0	2.2	2.7
Subsidies	2.0	1.1	0.9	0.5
Other current expenditure	2.7	2.6	2.6	2.5
Total current expenditure	**43.9**	**40.8**	**40.2**	**40.2**
Gross fixed capital formation	2.6	2.5	3.1	3.2
Other capital expenditure	1.3	1.5	1.3	0.9
Other (residual)	4.0	4.1	3.9	3.4
Interest expenditure	2.4	2.0	2.2	2.7
Total expenditure	**47.7**	**44.8**	**44.5**	**44.3**
General government balance (ESA2010)	**-2.9**	**-0.4**	**-0.1**	**-0.1**
Primary balance	-0.5	1.6	2.0	2.6
% change				
Taxes on production and imports	11.0	11.8	6.7	6.8
Current taxes on income, wealth, etc.	3.1	24.1	5.6	1.8
Social contributions	6.5	8.5	5.9	3.2
Sales and other current revenue	19.2	-4.4	12.4	-0.3
Total current revenue	**8.9**	**11.3**	**6.9**	**3.6**
Capital transfers received	162.6	-28.8	97.0	3.6
Total revenue	**10.6**	**10.2**	**8.5**	**3.6**
Compensation of employees	4.3	3.5	8.5	3.0
Intermediate consumption	12.3	8.9	15.1	1.7
Social transfers in kind via market producers	3.8	12.3	6.1	4.9
Social transfers other than in kind	3.5	6.9	2.9	5.1
Social payments	3.5	7.4	3.2	5.0
Interest paid	-10.7	-9.4	20.1	31.3
Subsidies	17.4	-40.4	-13.0	-40.1
Other current expenditure	13.7	8.1	7.2	-0.6
Total current expenditure	**5.1**	**3.5**	**6.9**	**4.1**
Gross fixed capital formation	18.9	7.1	33.8	9.4
Other capital expenditure	-37.3	30.9	-8.7	-27.2
Total expenditure	**3.8**	**4.4**	**7.9**	**3.6**
Nominal GDP, EUR bn	**214.7**	**239.3**	**259.3**	**270.0**

Table 7: Government debt developments

	2021	2022	2023	2024
ESA2010 government balance (% of GDP)	**-2.9**	**-0.4**	**-0.1**	**-0.1**
ESA2010 gross debt (% of GDP)	125.4	113.9	106.2	103.1
ESA2010 government balance	**-6.2**	**-0.9**	**-0.4**	**-0.3**
Gross debt	269.2	272.6	275.4	278.4
Change in gross debt	-1.2	3.3	2.8	3.0
Nominal GDP	214.7	239.3	259.3	270.0
Real GDP growth (% change)	**5.5**	**6.7**	**2.4**	**1.8**
Change in gross debt (% of GDP)	-0.6	1.4	1.1	1.1
Stock-flow adjustments (% of GDP)	-3.5	1.0	0.9	1.0
Gross debt ratio	**125.4**	**113.9**	**106.2**	**103.1**
Change in gross debt ratio	-9.5	-11.5	-7.7	-3.1
Primary balance	-0.5	1.6	2.0	2.6
"Snow-ball" effect	-6.5	-10.9	-6.6	-1.5
of which				
Interest expenditure	*2.4*	*2.0*	*2.2*	*2.7*
Real growth effect	*-7.0*	*-7.9*	*-2.7*	*-1.8*
Inflation effect	*-1.9*	*-5.0*	*-6.1*	*-2.4*
Stock-flow adjustments	**-3.5**	**1.0**	**0.9**	**1.0**
Implicit interest rate	*1.9*	*1.7*	*2.1*	*2.7*

ANNEX 2
Debt sustainability analysis

This Annex assesses fiscal sustainability risks for Portugal over the short, medium and long term. It follows the same multi-dimensional approach as the European Commission's 2022 Debt Sustainability Monitor, updated based on the Commission's 2023 spring forecast.

3.1. SHORT-TERM RISKS

Short-term risks to fiscal sustainability are low overall. The Commission's early-detection indicator (S0) does not signal major short-term fiscal risks (Table A2.1). ([19]) Gross financing needs are expected to remain moderate at around 10% of GDP in the short-term (i.e. over 2023-2024), although declining compared with the recent peak in 2020 (Table A2.1). Financial markets' perceptions of sovereign risk are investment grade, as confirmed by the spread and the 'BBB' (or equivalent) rating that the three main rating agencies have assigned to the Portuguese government debt.

3.2. MEDIUM-TERM RISKS

Medium-term risks to fiscal sustainability are high overall. The DSA for Portugal shows that, under the baseline, the government debt-to-GDP ratio is expected to remain at a high level over the medium-term (at 91.8% of the GDP in 2033), despite being on a continuously declining path (Graph A2.1). ([20]), ([21]) The assumed structural primary balance (a surplus of 1.9% of GDP) seems ambitious compared to past fiscal performance. At the same time, the baseline projections up to 2033 benefit from a favourable (although diminishing) snowball effect until 2030, notably thanks to the favourable impact of NextGenerationEU, with real GDP growth at around 0.8% of GDP over 2025-2033. Government gross financing needs are expected to slightly increase over the projection period, reaching 11% of GDP in 2033, slightly above the level forecast for 2024.

The baseline projections is stress-tested against four alternative scenarios to assess the impact of changes in key assumptions (Graph A2.1). For Portugal, all the stress tests scenarios would lead to worse results as compared to the baseline, with particularly adverse developments under the 'historical structural primary balance (SPB)' scenario. If the SPB gradually converged to a surplus of 0.4% of GDP (its historical 15-year average), it would result in a persistently higher projected debt-to-GDP ratio (about 9 pps.) higher than in the baseline in 2033. A permanent worsening of the macro-financial conditions, as reflected under the 'adverse interest- growth rate differential' scenario (i.e. 1 pp. higher than the baseline) would also lead to higher government debt-to-GDP ratio (around 8 pps.) by 2033, as compared with the baseline. As for the 'lower structural primary balance' scenario (i.e. SPB level permanently reduced by half of the cumulative forecast change), it would also provide to a higher government debt-to-GDP ratio by 2033 (about 4 pps.) compared with the baseline. A temporary worsening of financial conditions, as reflected in the 'financial stress 'scenario (i.e. temporarily increase of interest rates by 2.4 pps.), would also lead a slightly higher public debt-to-GDP ratio by 2033 (about 2 pps.) compared with the baseline.

Additionally, stochastic projections show a medium sensitivity of these projections against plausible unforeseen events (Graph A2.2). **(**[22]**)** These stochastic simulations point to a 22%

([19]) The S0 is a composite indicator of short-term risk of fiscal stress. It is based on a wide range of macro-financial and fiscal variables that have proven to perform well in the past in detecting situations of upcoming fiscal stress.

([20]) The assumptions underlying the Commission's 'no-fiscal policy change' baseline notably comprise: (i) a structural primary surplus, before ageing costs, of 1.9% of GDP as of 2024; (ii) inflation converging linearly towards the 10-year forward inflation-linked swap rate 10 years ahead (which refers to the 10-year inflation expectations 10 years from now); (iii) the nominal short- and long-term interest rates on new and rolled over debt converging linearly from current values to market-based forward nominal rates by T+10; (iv) real GDP growth rates from the Commission 2023 spring forecast until 2024, followed by EPC/OGWG 'T+10 methodology projections between T+3 and T+10, i.e. for 2025-2033 (on average 0.8%); (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, November 2020). For information on the methodology, see the 2022 Debt Sustainability Monitor.

([21]) Table A2.1 shows the baseline debt projections and its breakdown into the primary balance, the snowball effect (the combined impact of interest payments and nominal GDP growth on the debt dynamics) and the stock-flow adjustment.

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

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

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Gross debt ratio (% of GDP)	**134.9**	**125.4**	**113.9**	**106.2**	**103.1**	**100.1**	**97.7**	**96.0**	**94.4**	**93.2**	**92.3**	**91.9**	**91.8**	**91.8**
Changes in the ratio	18.3	-9.5	-11.5	-7.7	-3.1	-3.0	-2.3	-1.7	-1.6	-1.2	-0.8	-0.5	-0.1	0.0
of which														
Primary deficit	2.9	0.5	-1.6	-2.0	-2.6	-2.2	-1.8	-1.3	-1.1	-0.9	-0.7	-0.5	-0.3	-0.1
Snowball effect	10.9	-6.5	-10.9	-6.6	-1.5	-0.8	-0.6	-0.4	-0.5	-0.3	-0.2	0.0	0.2	0.1
Stock-flow adjustments	4.4	-3.5	1.0	0.9	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs (% of GDP)	20.8	12.2	11.1	10.6	9.8	9.5	10.1	10.3	10.2	10.0	9.6	11.8	11.6	11.4

Source: European Commission.

probability of the debt ratio in 2027 being greater than in 2022, entailing medium risk given the initial high level of debt. In addition, such shocks point to substantial uncertainty (i.e. the difference between the 10th and 90th debt distribution percentiles) surrounding the government debt baseline projections.

3.3. LONG-TERM RISKS

Long-term risks to fiscal sustainability are low overall. ([23]) The S2 indicator points to low fiscal sustainability risks. The indicator shows that, relative to the baseline, the SPB would not need to improve to ensure debt stabilisation over the long term. This result is underpinned by a favourable initial budgetary position (-1.5 pps. of GDP) and the projected decrease in ageing-related costs (contribution of -1.1 pps. of GDP). Ageing costs' developments are primarily driven by the projected decrease of public pension expenditure (contribution of -2.9 pps. of GDP), though pension spending will continue to increase over the next decade to reach a peak of 14.6% of GDP in 2035 before starting to decrease. Health and long-term care spending is projected to increase over the projection period (joint contribution of 1.7 pps. of GDP) (Table A2.2). However, a number of investments and reforms in the RRP contribute to supporting the efficiency of the Portuguese health care system.

Combined with the S1 indicator, long-term risks are assessed as low. Indeed, the S1 sustainability gap indicator signals that no consolidation effort would be needed to reduce debt to 60% of GDP by 2070. This result is driven by the favourable initial budgetary position (-1.8 pps. of GDP), which is partially offset by the high Portuguese government debt ratio (contribution of 0.9 pp. of GDP), and the projected ageing-related public spending (contribution by 0.8 pp. of GDP) (Table A2.2).

Finally, several additional risk factors need to be considered in the assessment. On one hand, risk-increasing factors are related to the recent increase in interest rates, contingent liability risks linked to State guaranteed credit lines, including those granted to firms and the self-employed during the COVID-19 crisis, and the negative net international investment position. On the other-hand, risk-mitigating factors include Portugal's comfortable cash buffer, relatively stable financing sources (with a diversified and large investor base) and the currency denomination of debt, as well as a debt management strategy targeting the smoothening of the debt redemption profile. In addition, the structural reforms under the NGEU/RRF, if fully implemented, could have a further positive impact on GDP growth in the coming years, and therefore further mitigate the debt sustainability risks.

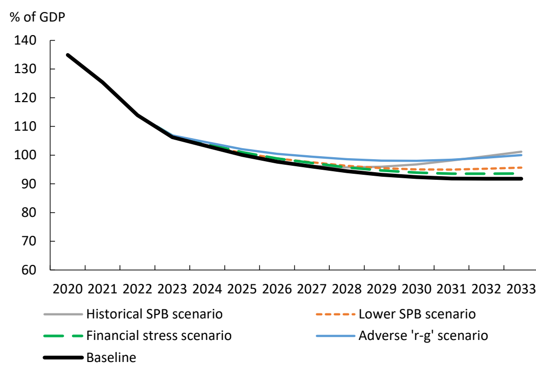
([23]) The S2 fiscal sustainability gap indicator measures the permanent fiscal effort (SPB adjustment) in 2024 that would be required to stabilise public debt over the long term. It is complemented by the S1 fiscal sustainability gap indicator, which measures the permanent fiscal effort required in 2024 to bring the debt-to-GDP ratio to 60% in the long term (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 pps. of GDP, 'medium risk' if it lies between 2 pps. and 6 pps. of GDP, and 'low risk' if the effort is negative or below 2 pps. of GDP. The overall long-term risk classification brings together the risk categories derived from S1 and S2. S1 may notch up the risk category derived from S2 when it signals a higher risk than S2. See the 2022 Debt Sustainability Monitor for further details.

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

		S1	S2
Overall index (pps. of GDP)		**-0.1**	**-2.6**
of which			
Initial budgetary position		-1.8	-1.5
Debt requirement		0.9	
Ageing costs		0.8	-1.1
of which	*Pensions*	-0.6	-2.9
	Health care	1.0	1.3
	Long-term care	0.3	0.4
	Others	0.1	0.2

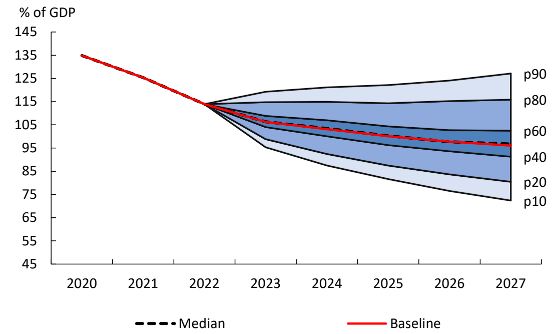
Source: European Commission.

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



Source: European Commission.

Graph A2.2: **Stochastic debt projections 2023-2027**



Source: European Commission.

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

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	HIGH	HIGH	HIGH	HIGH	HIGH	MEDIUM	LOW	LOW	LOW
		Debt level (2033), % GDP	91.8	101.2	95.7	100.0	93.6				
		Debt peak year	2022	2022	2022	2022	2022				
		Fiscal consolidation space	24%	41%	33%	24%	24%				
		Probability of debt ratio exceeding in 2027 its 2022 level						22%			
		Difference between 90th and 10th percentiles (pps. GDP)						54.8			

(1) Debt level in 2033. 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 2027 its 2022 level. Green: low probability. Yellow: intermediate. Red: high (also reflecting the initial debt level). (5) The difference between the 90th and 10th percentiles measures uncertainty, based on the debt distribution under 2000 different shocks. Green, yellow and red cells indicate increasing uncertainty.
Source: European Commission (for further details on the Commission's multidimensional approach, see the 2022 Debt Sustainability Monitor).

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