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Post-Programme Surveillance Report

Portugal, Spring 2021

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Spring 2021

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This report reflects information available and policy developments that have taken place until 14 April 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 spring forecast released on 12 May 2021 (with cut-off date 30 April 2021). References in this report to the Recovery and Resilience Facility do not constitute any assessment of the Portuguese Recovery and Resilience Plan and cannot in any way serve to pre-judge the Commission assessment of the Plan.

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⁽¹⁾ The executive summary of this report was adopted as Commission Communication C(2021)3945 on 27 May 2021. The rest of the report reflects the findings of the Staff Working Document (SWD(2021)129) 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

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

EXECUTIVE SUMMARY

This report presents the findings of the thirteenth post-programme surveillance (PPS) mission of Commission staff to Portugal, in liaison with ECB staff. Due to the existing travel restrictions, the mission took place in the form of online video meetings from 15 to 19 March 2021. Since the conclusion of the twelfth PPS mission in September 2020, Portugal's economic performance turned out somewhat better than previously projected, despite the large contraction caused by the COVID-19 pandemic. After a strong rebound in the third quarter of 2020, the economic recovery stalled towards the end of 2020 and in the first quarter of 2021 due to a new spike in infections and resulting restrictions. However, growth is expected to resume from the second quarter of 2021, helped also by the ongoing vaccination campaign. The new short-term outlook suggests that the economy is likely to return to its pre-crisis level in mid-2022, roughly half a year earlier than the expectation in the previous PPS review.

Portugal's economy contracted by 7.6% in 2020 as a result of the COVID-19 pandemic but the outcome was 1.7 percentage points more favourable than the projections stated in the previous post-programme review. Across the main GDP components, exports of services recorded the largest decline of 36.8% reflecting the country's large exposure to foreign tourism. The country's external balance expectedly deteriorated as the lost travel receipts were only partly offset by the improved balances of trade in goods and of primary income. Private debt ratios also worsened but are set to resume their downward trend along with the projected economic recovery in 2021 and 2022.

Government measures in support of jobs and incomes significantly cushioned the economic and social impact of the pandemic. The headline unemployment rate increased only slightly from 6.5% in 2019 to 6.9% in 2020 and employment dropped by only 1.7%. A more significant impact was observed in labour utilisation due to the large decrease in hours worked during the lockdowns. Continued government support to the hospitality sector during the initial period of economic recovery aims at avoiding cliff-edge effects on the labour market. The authorities remain committed to such an approach and are contemplating additional active labour market policies targeted at job seekers in the most vulnerable sectors.

The COVID-19 pandemic is taking a toll on Portugal's public finances. From a small surplus of 0.1% of GDP in 2019, the budget balance turned into a deficit of 5.7% of GDP in 2020, against the background of weaker cyclical revenue and increased spending needs. Despite this deterioration, the deficit in 2020 clearly outperformed the revised target of 7.3% set in the 2021 State Budget, with revenue holding up better than expected. The public debt-to-GDP ratio increased from 116.8% in 2019, to 133.6% in 2020, mainly owing to the unfavourable denominator effect, the primary deficit and a higher cash buffer. The crisis response provided targeted fiscal support in 2020, against a high degree of uncertainty. Public contingent liabilities are building up, however. Renewed momentum for fiscal-structural reforms remains key to enhance expenditure control and cost efficiency, strengthen the sustainability and resilience of the National Health Service, and tackle fragilities in state-owned enterprises. These would offer enhanced framework conditions for Portugal to maximise the beneficial impact of the Next Generation EU package.

Notwithstanding the impact of the pandemic, the Portuguese banking sector managed to improve most of its soundness indicators in 2020. The economic support measures, and particularly the moratoria on debt repayments, prevented a steep rise in defaults. Consequently, the ratio of non-performing loans fell to a new low, but the actual performance will only become clear once the moratoria expire. To prevent a cliff-edge when the moratoria expire, banks have continued to build up loan loss provisions at the expense of their profit margins, recognising the importance to actively monitor and report borrowers' credit quality.

Risks to financing conditions and the capacity to repay remain low. Financing needs surged in 2020 along with the accumulation of a substantial cash buffer, while financing conditions remained favourable. Meanwhile, public indebtedness is projected to resume its downward path as of 2021, after a sharp increase in 2020. Nevertheless, continuous efforts in the past to smoothen the redemption profile of

public debt, extend the debt maturity, and contain interest costs, have mitigated vulnerabilities. Portugal's access to the EU's new instruments – Support to mitigate Unemployment Risks in an Emergency (SURE) and the Recovery and Resilience Facility (RRF) – also contribute to enhance its financing terms and repayment capacity.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the thirteenth post-programme surveillance (PPS) mission to Portugal between 15 and 29 March 2021. Due to travel restrictions imposed during the COVID-19 pandemic, the mission took place in the form of online video meetings. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. The mission was coordinated with an IMF staff visit. PPS monitors economic, fiscal and financial conditions to assess the repayment capacity of a country that has received financial assistance⁽³⁾. While there is no policy conditionality under PPS, the Council can issue recommendations for corrective actions if necessary and where appropriate. PPS is biannual in terms of reporting and missions.

The current PPS reporting focused on the most relevant macro, fiscal and financial developments. Structural reforms in the real sector were analysed only in their macroeconomic context. The objective is to minimise overlaps with work and reporting related to the Commission assessment of reforms envisaged or implemented in the context of the European Semester and the Recovery and Resilience Facility.

The outbreak and spread of the COVID-19 pandemic is having an unprecedented impact on the economic and fiscal developments in Portugal as in all other EU Member States. The Portuguese government reacted to COVID-19, as early as 12 March 2020, with a comprehensive package of measures, addressing the immediate health policy challenges and implementing social distancing measures. The package also included measures to counter the negative economic impact of COVID-19, e.g. guarantee programmes for affected companies and income support measures. The policy response is being continuously adjusted to the epidemic, economic and social developments. The economic and fiscal impact of all these measures depends on the duration and the magnitude of disruption at global and regional

levels. This extraordinary situation creates substantial uncertainties over data reporting and forecasting.

This report reflects information available and policy developments that have taken place until 14 April 2021. However, the macroeconomic and budgetary projections, including those underlying the debt sustainability analysis, are in line with the Commission 2021 spring forecast released on 12 May 2021 (with cut-off date 30 April 2021). References in this report to the Recovery and Resilience Facility do not constitute any assessment of the Portuguese Recovery and Resilience Plan and cannot in any way serve to pre-judge the Commission assessment of the Plan.

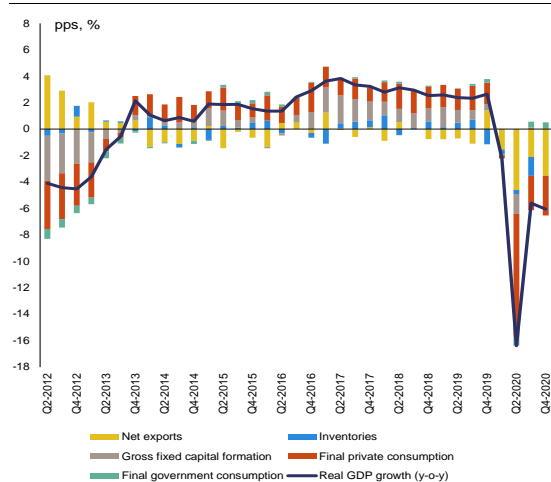
⁽³⁾ PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Portugal's economy contracted sharply in 2020 as a result of the COVID-19 pandemic but proved more resilient than expected. GDP dropped by 7.6% in 2020 or 1.7 percentage points less than the projections stated in the previous post-programme review. Across the main GDP components, exports of services plunged by 36.8% reflecting a much steeper fall of about 75% in the number of overnight stays by non-residents. Exports of goods dropped at a much lower rate but overall the external sector contributed around two fifths of the GDP decline. The main positive surprise was observed in investment, which declined by just 1.9% (excluding inventories). Investment in construction even increased by 4.6% over the year against a drop by 12.0% in equipment investment. Although households' income was to a large extent protected by government social measures, private consumption decreased by 5.9% due to a surge in forced and precautionary savings. Overall, households' savings rose from 7.1% of their income in 2019 to 12.8% in 2020.

Graph 2.1: Real GDP growth and components

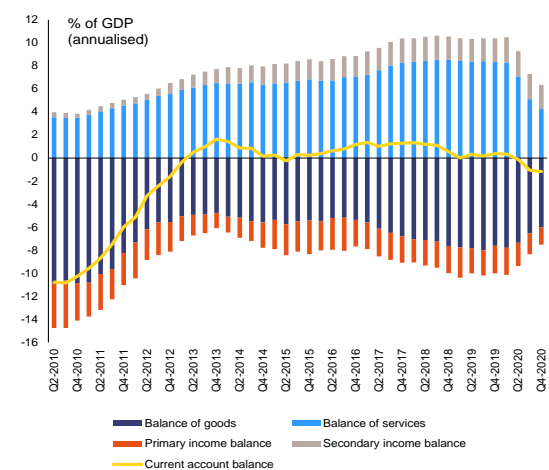


Source: Eurostat

Resurgence in infections temporarily clouded recovery prospects. As the quarterly growth rates followed closely the evolution of the pandemic and the corresponding restrictions, the recovery stalled towards the end of 2020 and the strong rebound of

13.4% (q-o-q) in Q3-2020 was followed by a marginal increase of 0.2% (q-o-q) in Q4-2020. A further acceleration in infections triggered a new strict lockdown from mid-January 2021 resulting in reduced economic activity. However, the reported decline in retail sales, industrial output and services shows that the economic contraction in Q1-2021 is likely to be much less significant as compared with the previous lockdown in spring 2020. This is also visible in the Commission's economic sentiment indicator for Portugal where the level in Q1-2021 remained well above the figures from the first lockdown in 2020. With the gradual relaxation of the social distancing measures, the economy is expected to start recovering again from the second quarter of 2021. A more significant rebound is projected to take place in the third quarter of 2021 under the assumption that the progress with vaccinations would facilitate traveling within the EU. According to the Commission 2021 spring forecast, GDP is expected to increase by 3.9% in 2021 and 5.1% in 2022. The balance of risks is still tilted to the downside due to the country's large exposure to foreign tourism where significant uncertainties remain.

Graph 2.2: Current account balance



Source: Banco de Portugal

The current account (CA) moved from a surplus of 0.4% of GDP in 2019 to a deficit of 1.2% in 2020. The surplus in trade in services decreased from 8.3% of GDP in 2019 to 4.2% in 2020 due mainly to the receipts lost from foreign tourism and related passenger transport services,

particularly in the aviation sector. On the other hand, the deficit in trade in goods improved from 7.6% of GDP in 2019 to 6.0% in 2020 reflecting lower equipment investment. Trade in goods also benefited from positive terms of trade against the backdrop of lower crude oil prices. Exports of goods dropped by 7.8% in real terms but performed slightly better than the demand from the main trading partners. The balance in primary income also improved from -2.4% of GDP in 2019 to -1.5% in 2020 due to lower dividend payments by foreign-owned companies. The surplus in the balance of secondary income was stable at 2.1% of GDP including an unchanged net inflow from migrants' remittances of 1.5% of GDP.

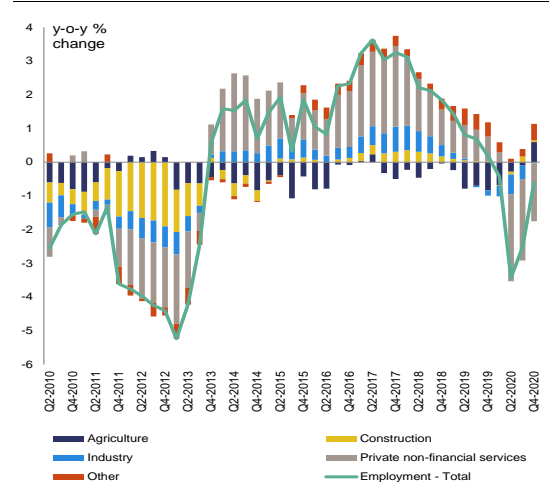
The net international investment position (NIIP) deteriorated from -100.5% of GDP at the end of 2019 to -105.4% as of the end of 2020. This was fully driven by the contraction in GDP. In absolute terms, the NIIP improved by EUR 1.6 billion during 2020. The change included a positive contribution from net flows (EUR 0.8 billion) and positive net asset valuations reflecting market fluctuations in the prices of monetary gold and corporate stocks.

The labour market showed significant resilience helped by government measures in support of jobs and incomes. Consequently, the headline unemployment rate increased only slightly from 6.5% in 2019 to 6.9% in 2020 and employment dropped by only 1.7%, being affected much less by the pandemic than GDP. However, the headline indicators did not capture all adverse impacts. In particular, registered unemployment increased more than the labour force survey suggests and hours worked were more severely affected. The total number of hours worked dropped by 9.2% in 2020 with a very substantial decline of 23.8% (y-o-y) in Q2-2020. This also entailed a substantial drop in labour utilisation along with the contraction in the labour force by 1.4% in 2020. On the other hand, the working age population (15 to 75 years) increased by 0.2% after a continuous contraction in the previous years, according to the labour force survey, implying a positive net flow of migrants during the pandemic. This could potentially improve the labour contribution to GDP growth over the medium term provided that migrants are successfully integrated into the labour market.

Policy measures would have to address scarring effects, notably in the hospitality sector.

Although unemployment remained relatively low at the beginning of 2021, at 6.9% in February, government measures in support of the labour market remained essential for protecting jobs and income, particularly in the most affected sectors. During the critical period of the crisis in 2020, more than a quarter of the labour force benefited from various temporary forms of state support. Wage support was channelled mainly through employers and entailed compensations for temporary reductions in working hours or furloughs. The scope of support was somewhat smaller during the lockdown at the beginning of 2021, as manufacturing firms in particular were significantly less affected by the new restrictions. This was also evident in the relatively stable number of newly registered job seekers at the beginning of 2021, which remained well below the peak in the first lockdown in 2020. Nevertheless, the expected slower recovery in the hospitality sector requires further government support during the period of economic recovery and an only gradual phase-out of measures aimed at avoiding cliff-edge effects on the labour market. This would entail adaptation of policies to target the most vulnerable sectors and active labour market policies for adjusting skills.

Graph 2.3: Employment evolution by sectors



Source: Eurostat

The Harmonised Index of Consumer Prices (HICP) dropped by 0.1% in 2020 after a small increase of 0.3% in 2019. The steep drop in energy prices in Q2-2020 was the main factor

behind this development. Prices of non-energy industrial goods and services were also in negative territory throughout the year while only food prices retained an upward trend, mainly for unprocessed agricultural products. The index of consumer prices deviated substantially from the GDP deflator, which accelerated from 1.7% in 2019 to 2.5% in 2020. Two major factors contributed to the higher deflator – the positive terms of trade in the external sector and the large upward impact of the reduced hours worked on the government consumption deflator. Looking forward, consumer price inflation is projected to gradually pick up in 2021 and 2022 in line with the expected economic recovery, supported by some pent-up demand from savings accumulated during the pandemic.

Graph 2.4: HICP and House Price Index



Source: Eurostat

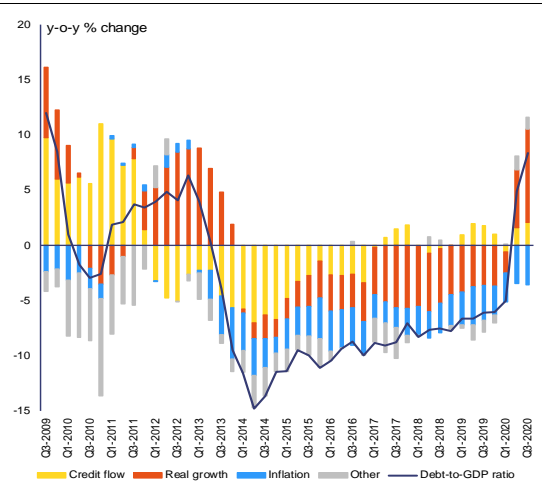
House prices continued growing during the pandemic albeit at a somewhat slower pace. Growth in house prices slowed from 9.6% in 2019 to 8.4% in 2020. The major slowdown occurred in the second and third quarters of 2020. House prices re-accelerated again in the last quarter of the year when the growth rate reached 8.6% y-o-y. The number of property transactions fell by 5.3% in 2020, mainly driven by the contraction during the strict lockdown in the second quarter of the year. Sales volumes recovered in the second half of the year to levels close to those in the previous year. A more significant correction was observed on the rental markets in regions with a large exposure to tourism where many housing properties had been used for commercialised

services related to tourism. Nevertheless, on a full-year national basis the index of actual rental prices, as measured within the overall index of consumer prices, increased by 2.6% relative to 3.2% in 2019. In the light of the low interest rate on mortgage loans and increased savings during the pandemic, demand for housing properties is likely to pick up during the projected economic recovery. On the other hand, the projected protracted recovery in tourism is likely to partly offset the demand pressure on properties in popular tourism areas.

2.2. PRIVATE DEBT

The economic crisis in 2020 temporarily derailed the downward trend in private indebtedness. The main factor behind the increased private debt ratio was the denominator effect of the GDP contraction. To a much lesser extent, the ratio was also affected by the increase in the absolute value of private debt, reflecting, inter alia, the impact of the moratoria on debt repayments during the pandemic. The projected economic recovery is set to reinstate the positive trend observed prior to the crisis though some of the most affected businesses may opt for a longer repayment schedules that would slow the overall pace of deleveraging. On the other hand, the substantial increase in deposits in 2020 could reduce the need for new credits and support the debt reduction.

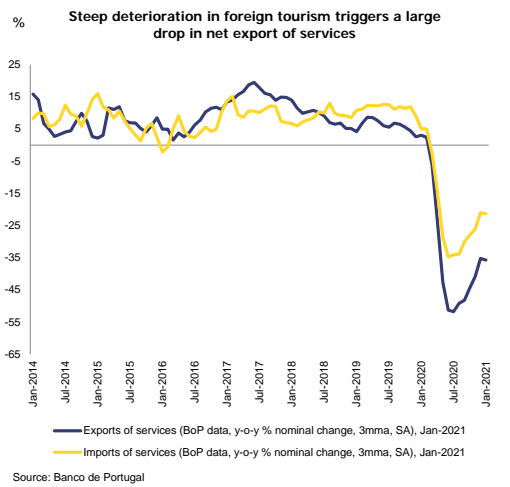
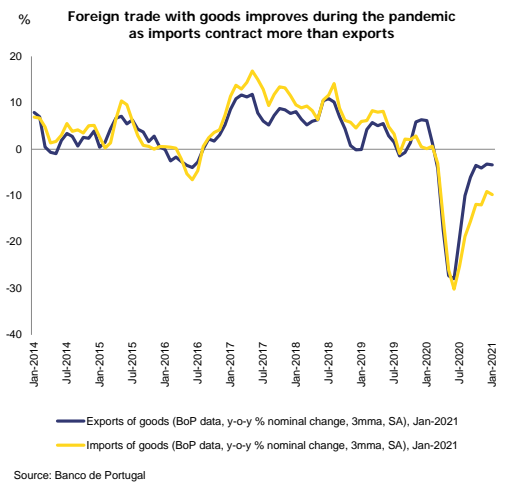
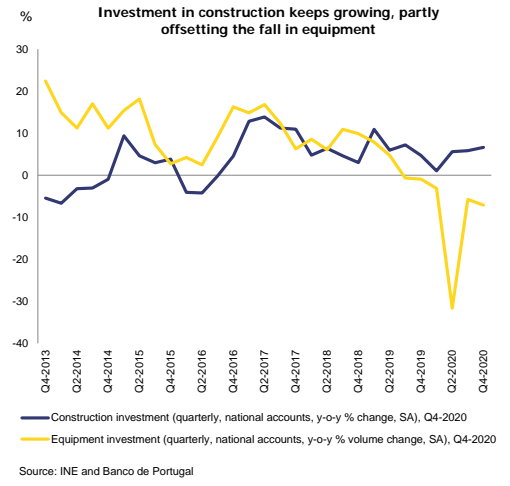
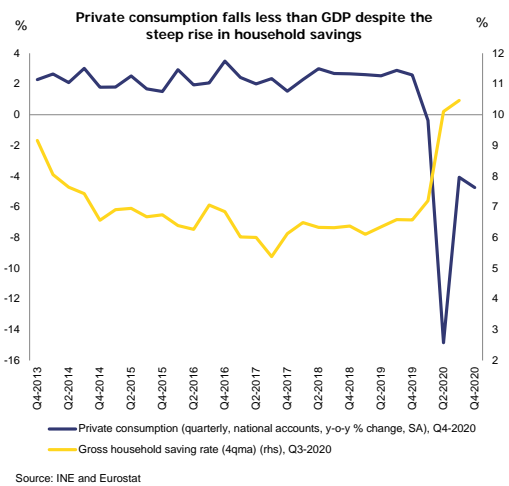
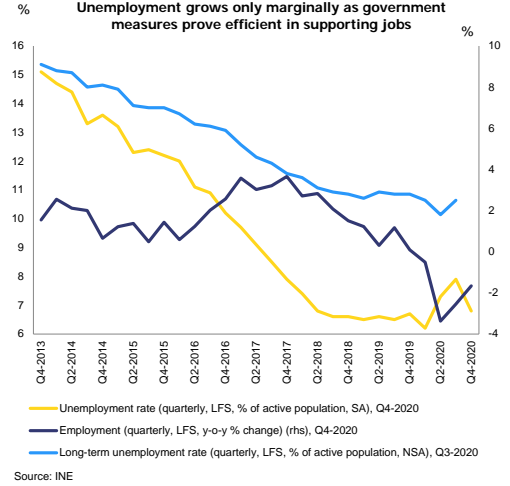
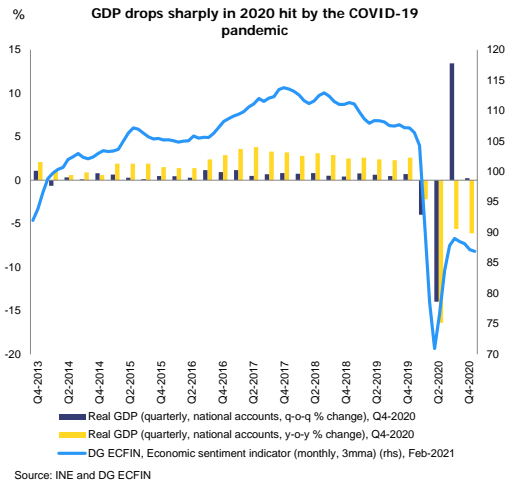
Graph 2.5: Private indebtedness growth and components



Source: Eurostat, Banco de Portugal

Consolidated private debt was estimated at 161.2% of GDP as of end-2020. The ratio increased from 148.8% at the end of 2019 but around three quarters of this increase was driven by the decline in GDP. Both household and corporate indebtedness increased during this period to 68.3% and 92.9% respectively. The debt accumulation was slightly faster in the corporate sector, whose exposure to credits under moratoria appeared significant at 33.6% of total credits as of the end of 2020 relative to 16.2% for the household sector. The breakdown of corporate debt by the size of company shows that the debt accumulation appeared on the accounts of micro firms and SMEs while the debt burden in large corporations declined in 2020.

Graph 2.6: Economic developments



Source: European Commission

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE AND OUTLOOK

The general government balance in 2020 was hard hit by the COVID-19 crisis. From a small surplus of 0.1% of GDP in 2019, the operation of automatic stabilisers and fiscal policy support drove the general government balance to a deficit of 5.7% of GDP in 2020. Total revenue decreased by 5% y-o-y in 2020, less than GDP. On the one hand, this outcome reflected an increase in the revenue from social contributions (by 1.2% y-o-y) and a relatively mild decrease in the revenue from taxes on income and wealth (by 3.7% y-o-y) and, on the other hand, a contrasting fall-off in the revenue from taxes on production and imports (by 9.1% y-o-y). At the same time, total expenditure increased by 7.8% y-o-y in 2020. Although increases were prevalent across most spending lines, the contributions to expenditure growth from subsidies (by 3 pps.) and capital transfers (by 1.6 pps.) – under which the bulk of crisis mitigation measures fell – were particularly sizeable. Likewise, the general government primary balance (this is, the budget balance excluding interest expenditure) deteriorated from a solid surplus of 3% of GDP in 2019, to a deficit of 2.8% of GDP in 2020. The general government balance continued to be affected by one-off measures in 2020 (this is, measures that are intrinsically non-recurrent), namely the third activation of Novo Banco's contingent capital mechanism, which amounted to around 0.5% of GDP. Excluding the impact of all one-off measures, Portugal would have achieved a smaller deficit of 5% of GDP in 2020.

The worsening of the general government balance in 2020 was nevertheless less severe than planned. Despite its deterioration, the deficit in 2020 ended up being clearly below the latest target of 7.3% of GDP planned in the 2021 State Budget. Compared with this target, $\frac{3}{4}$ of the lower-than-planned deficit in 2020 owed to revenue holding up better than expected, in particular revenue from social contributions, personal and corporate income tax. In addition, the lower-than-planned deficit was also underpinned by lower-than-planned intermediate consumption (by 0.2% of GDP compared with the 2021 State Budget), reflecting pandemic-related behavioural changes, as well as recurrent outcomes on the expenditure side – which had systematically occurred also in

the years preceding the COVID-19 pandemic – including interest expenditure and public investment typically turning out below government plans (jointly by 0.2% of GDP in 2020).

The steady decrease of the public debt-to-GDP ratio has been temporarily reversed in 2020.

After having decreased to 116.8% in 2019, and following its steadily downward path since its latest peak in 2016, the public debt-to-GDP ratio spiked to 133.6% in 2020. In addition to the above-mentioned primary deficit, the snowball effect (which translates the differential between interest rates and nominal GDP growth) and the stock-flow adjustment (which reflects the difference between the change in public debt and the budget balance) both concurred to this increase (by 9.3% and 4.5% of GDP, respectively). As regards the former, the unfavourable denominator effect arising from the observed contraction of nominal GDP (6.4% of GDP) added to the non-negligible interest burden (2.9% of GDP), which, nevertheless, has been moderating consistently since 2014. As regards the latter, it reflected, among other factors, the substantial increase of the cash buffer by 4.7% of GDP in 2020 (see Section 5).

Portugal's crisis response provided targeted fiscal support in 2020, against a high degree of uncertainty.

The package of crisis mitigation measures implemented in 2020 was multipronged and gradually fine-tuned as the health and economic situation evolved over the year, leading to an overall deficit-increasing impact of around 3% of GDP. In a first round, measures were taken to strengthen the response capacity of the National Health Service (NHS), including the purchase of personal protective equipment and ventilators, as well as the payment of overtime and additional hiring of healthcare workers (with a deficit-increasing impact of around 0.5% of GDP at year-end). Shortly afterwards, additional measures were taken to protect jobs and livelihoods, provide adequate social support and safeguard firms' business continuity, which constituted the bulk of the overall package of measures (with a deficit-increasing impact of around 1% of GDP at year-end). The most important of these measures was undoubtedly a tailor-made short-time work scheme – commonly designated as “simplified lay-off” in Portugal – which allowed for the temporary

interruption of work or reduction of normal working time, in combination with an exemption from employers' social security contributions (with a deficit-increasing impact of around 0.7% of GDP at year-end).⁽⁴⁾ Subsequently, as restrictions were eased somewhat over the summer, new measures –taking effect as of July 2020 – were geared towards helping firms resume their activity. These notably included making the first and second pre-payments under the corporate income tax non-mandatory in 2020 under certain conditions (with a deficit-increasing impact of 0.3% of GDP at year-end), thereby partially lifting the obligation to anticipate during the year part of the liability resulting from the tax settlement in 2021, with respect to the corporate income of the former year. In addition, two Portuguese airlines – TAP Air Portugal and SATA Air Açores – benefited from rescue aid for 0.7% of GDP in 2020 (see Section 3.2).

Portugal also supported firms through “liquidity measures”, which have no immediate budgetary impact but constitute contingent liabilities. Several publicly guaranteed credit lines to firms were launched in 2020 – focusing on different target groups of firms, such as small and mid-caps, medium-sized firms, firms providing accommodation and food service activities, or travel agencies. It should be noted that most of these credit lines were under the umbrella of a publicly guaranteed scheme for investment and working capital loans to be operationalised through commercial banks, for which Portugal sought and obtained the Commission's approval on 4 April 2020, as amended on 22 December 2020 – in the context of the State aid Temporary Framework⁽⁵⁾ – for a maximum amount of EUR 13 billion (6.4% of GDP). The individual financial ceilings of the credit lines launched in the course of 2020 added up to a maximum amount of

around EUR 8 billion (4% of GDP)⁽⁶⁾, whose take-up was close to 90% at the end of 2020. The size of the public guarantee applicable to each credit line ranged between 80% and 90% of the granted loan, on which basis public guarantees were reported to have reached in this context more than 3% of GDP at the end of 2020.⁽⁷⁾ As a general rule, public guarantees constitute contingent liabilities for the government and may negatively impact the budget balance when certain specific conditions prevail, and in the amount that they are eventually called on. While the 2021 State Budget assumed that the materialisation of these public guarantees would be marginal in 2021 (at below 0.1% of GDP), other sources⁽⁸⁾ estimated that the loss ratio of some of the corresponding credit lines could be 16% *ab initio*, thereby pointing to a potentially higher budgetary risk over the short to medium term.

Deferrals of tax and social contribution payments within 2020 also helped provide additional liquidity to firms. Portugal deferred to the second half of 2020 a number of tax and contributory obligations, including two thirds of social security contributions and payments under the most yielding taxes, such as value-added and personal income tax. While these measures were ultimately not fully budget-neutral – as the associated payments were not always carried out in the second half of the year⁽⁹⁾ – their deficit-increasing impact was nevertheless contained (at around 0.1% of GDP).

The effects of the COVID-19 pandemic continue to affect Portugal's public finances in 2021. According to the 2021 State Budget, the budget balance in 2021 was planned to improve markedly to a deficit of 4.3% of GDP, supported by the expected economic recovery and the lower fiscal burden exerted by the crisis mitigation measures. However, the COVID-19 surge in January 2021

⁽⁴⁾ In its original design, it provided a benefit to eligible firms to cover 70% of the employees' compensation, with employees' compensation equalling two-thirds of their reference gross wage, as well as the exemption from the employers' social security contributions. Eligible firms should have suspended their activity or experienced revenue losses of at least 40%.

⁽⁵⁾ The Commission adopted on 19 March a Temporary Framework (revised subsequently) to enable Member States to use the flexibility foreseen under State aid rules to support the economy in view of the COVID-19 outbreak.

⁽⁶⁾ Portuguese Court of Auditors; Report No 1/2021-AEO: “COVID-19 – Budgetary execution, debt and guarantees at 30 September 2020”.

⁽⁷⁾ Portuguese Public Finance Council; Report No 2/2021: “Economic and budgetary outlook – 2021-2025”; March 2021.

⁽⁸⁾ *Idem*.

⁽⁹⁾ Possibly due to insolvencies or a deterioration in compliance culture.

called for additional measures to sustain the economy – including schemes to support employment, livelihoods, and business activity – with an estimated deficit-increasing impact of around $\frac{3}{4}$ % of GDP. As a consequence, the overall package of crisis mitigation measures in 2021 is presently assessed as being broadly in line with that of 2020, thereby driving the deficit in 2021 upwards. Conversely, and in contrast to 2020, one-off measures are overall expected to support the reduction of the deficit in 2021, mostly owing to one-off revenue related to the reimbursement of the pre-paid margin that had been deducted from the financial assistance loan granted by the European Financial Stability Facility (EFSF) (0.5% of GDP). All factors considered, the deficit is projected to reach 4.7% of GDP this year, according to the Commission 2021 spring forecast. This was deemed consistent with a projected decrease of the public debt-to-GDP ratio to 127.2% of GDP in 2021 – thus resuming its downward path – with the swifter decline than that of the deficit partly owing to the assumed pre-financing of 13% of the total amount allocated to Portugal under the Recovery and Resilience Facility (around 1% of GDP). The latter was factored in as a financial transaction, contributing to a negative stock-flow adjustment and leading to an ensuing debt-reducing effect.

The fiscal outlook for 2022 continues to be surrounded by a high degree of uncertainty. According to the Commission 2021 spring forecast, the worsening of the budget balance is expected to be temporary. The deficit is forecast to improve to 3.4% of GDP in 2022, as the economic recovery gains momentum, supported by the implementation of Portugal’s Recovery and Resilience Plan, and the phasing-out of the crisis mitigation measures. Against that background, the public debt-to-GDP ratio is projected to further decline to 122.3% next year. At the same time, the fiscal outlook remains surrounded by an unprecedentedly high degree of uncertainty, which stems, among other factors, from the possible materialisation of contingent liabilities, linked to publicly guaranteed credit lines and some public corporations. Importantly, these are on top of pre-pandemic risks related to contingent liabilities arising from previous bank support measures.

3.2. POLICY ISSUES

The profile, design and quality of fiscal support remain central issues. On 3 March 2021, the Commission adopted a Communication providing further policy orientations to facilitate the coordination of fiscal policies.⁽¹⁰⁾ Fiscal policy should remain agile and adjust to the evolving situation, while avoiding a premature withdrawal of fiscal support. Therefore, crisis response measures should be timely, temporary, and targeted, with a view to maximising support without pre-empting medium-term fiscal strategies. It would be important for Member States with high public debt-to-GDP ratios – with Portugal being a case in point – to pursue prudent fiscal policies, while preserving nationally financed investment and making use of grants under the Recovery and Resilience Facility to fund additional high-quality investment projects and structural reforms. A refocusing of fiscal policies towards achieving prudent medium-term fiscal positions, at the appropriate moment, including by phasing out support measures, will contribute to ensuring fiscal sustainability in the medium term

Structural upward pressures on current government expenditure were compounded by the COVID-19 crisis. Wage expenditure expanded by 3.7% y-o-y in 2020. Although the COVID-19 outbreak required the payment of overtime and additional hiring in the NHS, around $\frac{3}{4}$ of this increase did not stem from the pandemic but reflected instead the gradual unfreezing of pay progression in the public sector and retroactive mitigating measures for special careers⁽¹¹⁾, combined with the continuous growth of the public workforce in sectors other than healthcare. In this respect, it should be noted that half of the average increase of the public workforce by 2.2% y-o-y in 2020 does not appear to have concerned healthcare workers. Likewise, the recurrent increases in low pensions – above the reference rate for regular pension indexation (linked to inflation and GDP growth) – and the sequential broadening of

⁽¹⁰⁾ Communication of 3 March 2021 from the Commission to the Council: “One year since the outbreak of COVID-19: fiscal policy response”; COM(2021) 105 final.

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

pathways to early retirement, on top of the underlying upward trend driven by demographic ageing, translated into an increase by 3.3% y-o-y in pension spending falling under the responsibility of Social Security in 2020. These structural pressures were aggravated by the sharp rise in unemployment benefit payments, which increased – albeit from a low base – by 27.5% y-o-y in 2020.

Some underlying efficiency gains may nevertheless have been achieved in intermediate consumption in 2020. The observed increase in intermediate consumption by 1.4% y-o-y in 2020 masked possible savings if the additional pandemic-related expenditure were excluded from that expenditure item (on which basis it could have decreased by around 4% y-o-y). The ongoing bottom-up review of public expenditure – which was initiated in 2016 in order to enhance the efficiency of public spending in specific areas – may have contributed to this result (in fact, the 2020 State Budget had set a modest target of 0.1% of GDP for efficiency gains in this context). However, such a claim cannot be ascertained due to the current practice of not carrying out ex-post evaluations of the achieved savings. There are some signs that spending reviews could lose momentum in 2021 (since the corresponding target for efficiency gains was reduced by close to 30% y-o-y in the 2021 State Budget), but there appears to be available scope to make them a more prominent and structural feature of Portugal's budgetary framework.

A stronger budgetary framework would offer enhanced conditions for the economic recovery. While the 2015 Budgetary Framework Law (BFL) could strengthen overall budgetary planning and monitoring through a stronger medium-term focus and enhanced transparency, its effective implementation has experienced systematic delays. In 2020, the third amendment to the 2015 BFL preserved the main gist of the original legal basis, but brought about another significant postponement. From this results that the full and effective implementation of the 2015 BFL is now only planned for the second half of 2026, in the context of the preparation of the 2027 State Budget.⁽¹²⁾ While some of the new provisions were already implemented for the 2021 State Budget, the long-delayed Decree-Law establishing

the new performance-oriented budgetary programmes will not come to light during the first half of the current year. The implementation of the 2015 BFL should come hand-in-hand with a significant upgrade of the information systems for public financial management, as well as full adherence to the new accrual-based accounting system (that is, the “*Sistema de Normalização Contabilística para as Administrações Públicas*”, SNC-AP), which are expected to take effect in a gradual fashion across government sectors and bodies. Making decisive progress with the implementation of these reforms as a means to strengthen expenditure control, cost efficiency, and appropriate budgeting remains key. It would be particularly useful for the smooth implementation of the Recovery and Resilience Plan, and facilitate the rechannelling of public resources to new strategic priorities, such as the need to deliver the green and digital transitions.

At the outset of the COVID-19 pandemic, the NHS had already been facing a challenging financial situation for years. Its expenditure had been on an accelerating path since 2015 (driven by spending on wages, drugs, and medical devices) and, year after year, initial budgets had proven to be insufficient (reflecting weaknesses in budgeting and cost-efficiency). As a result, public hospitals had accumulated a sizeable stock of arrears, which despite the non-negligible decrease from the latest peak of around 0.5% of GDP in November 2017, remained at around 0.3% of GDP on average over 2019. Against that background, Portugal had established a track record of recurrent bailouts by the government, which had not succeeded in avoiding a systematic vicious cycle of hospitals' indebtedness, with knock-on effects on supply-chain relationships.

The planned reforms to strengthen efficiency in the NHS came to a temporary halt in the presence of the COVID-19 pandemic. The design of a comprehensive plan to improve the sustainability of the NHS and tackle the root causes of arrears got under way in 2019. It was expected to introduce an enhanced governance model for NHS hospitals, with a view to granting them greater autonomy in terms of investment and hiring decisions, in combination with enhanced monitoring and stronger accountability. This strategy crucially hinged upon making best use of the planning and management tools foreseen in the

⁽¹²⁾ Law No 41/2020 of 18 August.

current legal framework, such as revamping management contracts to strengthen performance-based practices, and ensuring the wide-spread approval of hospitals' budget and activity plans based on compliance with quantitative and qualitative targets that would foster sustainability. Since the COVID-19 outbreak, however, only limited progress has been made in this regard. Hence, the decrease of the NHS deficit (by 0.2% of GDP) and the reduction of the stock of arrears (by slightly below 0.2% of GDP) mostly reflected the additional financing – in particular, the higher allocation foreseen in the 2020 State Budget (by 0.5% of GDP) and the in-year reinforcement in response to COVID-19 pandemic (by 0.2% of GDP). This additional financing did not explicitly reflect efficiency considerations and coincided with a sharp decrease in hospital procedures not directly related to the COVID-19 pandemic. ⁽¹³⁾

related to SOEs inside the perimeter of general government), driven by the unfavourable denominator effect. In parallel, the government took legal steps to prevent private contractors from receiving financial compensation, when contractually due, for losses incurred during the COVID-19 outbreak, for example in view of reduced traffic in motorways under public-private partnerships following confinement restrictions.

Risks for the financial sustainability of state-owned enterprises (SOEs) increased on the back of the COVID-19 pandemic. Measures to identify and correct deviations from the approved budgets of SOEs in good time, as well as to improve transparency and reporting standards are being implemented at a gradual pace. Following an important improvement in 2019, the aggregate net income of SOEs in 2020 was significantly affected by the COVID-19 crisis. The fallout was particularly strong for the SOEs that were more vulnerable to the direct consequences of containment measures, notably those operating in the transport sector. In this context, both TAP Air Portugal (the country's flag carrier) and SATA Air Açores were granted in 2020 rescue aid of EUR 1.2 billion (0.6% of GDP) and EUR 132.5 million (0.1% of GDP), respectively. Taking into account the economic and financial situation of these corporations, both operations were classified as capital transfers with direct deficit-increasing impact. Moreover, other transport SOEs (including the SOEs operating the Lisbon and Porto subways or the national rail network) received either capital injections or loans from the government for around 0.4% of GDP. Following steady decreases in recent years, the debt of SOEs increased from 16.1% of GDP at the end of 2019, to 16.6% of GDP at the end of 2020 (of which 13% of GDP

⁽¹³⁾ Which reflected the need to channel resources to fight the COVID-19 pandemic and patients' fear of contracting the virus while at the hospital.

4. FINANCIAL SECTOR

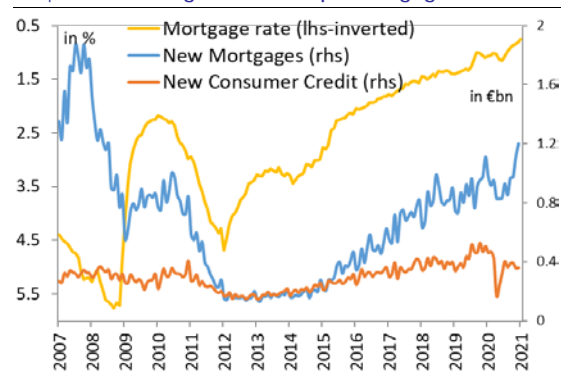
4.1. FINANCIAL STABILITY

Most soundness indicators have improved on account of the support measures. Portugal's banks made good use of the economic boom of the past years to off-load non-performing legacy assets, cut costs, and concentrate on core activities. That impetus was partly carried over into 2020 notwithstanding the pandemic crisis. In parallel, the comprehensive economic support measures that avoided widespread scarring of the economic tissue also prevented a steep rise in corporate and households' defaults. Consequently, the system's aggregate non-performing loans' ratio fell to new lows. At the same time, capital adequacy ratios (CAR) augmented as banks retained earnings slightly increased – increasing the capital ratios' numerator – whereas the state-guaranteed loans diminished the balance sheet's average risk weight, decreasing the CAR's denominator. The pandemic and the lock-down measures sparked fear and influenced consumption patterns negatively whilst pushing the 2020 savings rate to twice the preceding years' average. As deposits increased much faster than credit, the loan-to-deposit ratio fell by 4.2 percentage points between September 2019 and September 2020 to 73.1%. However, the deep recession hitting the Portuguese economy caused a widespread increase in the banks' loan loss provisions, which brought their 2020 profitability close to zero.

Bank lending has grown, supported by affordable mortgages and public guarantees. Private sector loans in Portugal increased by 4.8% y-o-y in 2020, over 4 percentage points faster than in the previous year. Household credit augmented by 1.7% y-o-y driven mainly by an increase of 2.5% y-o-y in mortgage lending. The average

interest rate for housing loans continued to drop, reaching just 0.72% in February 2021, 34 basis points lower than in February 2020 (Graph 4.1). The decrease in interest rates is reflected in the annual mortgage attribution, which in 2020 reached its highest level since 2007 (Graph 4.1). Unsurprisingly, given the COVID-19 pandemic, consumer and other credit, which accounts for 21.2% of household loans, fell by 0.9% in 2020. The COVID-19 crisis and the related mitigating measures had a major impact on corporate credit, which rose by 10.3% after falling by 3.3% in 2019. With over 50% of the temporary framework (worth EUR 13.4 billion) attributed, Portugal is amongst the Member States with highest percentage of public sector guaranteed loans paid out (see Section 3.1). At the end of March 2021, guaranteed loans represented as much as 11% of the stock of corporate loans.

Graph 4.1: Falling interest rates pull mortgage attribution



Source: Statistical Bulletin (B.7.1.6), Banco de Portugal

Banks' balance sheets proved resilient in 2020. The dynamics that led the banking system from a record high NPL ratio of over 17% in 2016 down to 6.2% as of end-2019 continued notwithstanding the pandemic and stood at 4.9% as of the

Table 4.1: Financial stability indicators

in %	Portugal								Euro area		EU
	Q4-2016	Q4-2017	Q4-2018	Q3-2019	Q4-2019	Q1-2020	Q2-2020	Q3-2020	Q3-2020	Q3-2020	
Non-performing loans	17.2	13.3	9.4	7.7	6.1	5.9	5.5	5.3	2.7	2.7	
o/w NFC sector	29.4	25.2	18.5	15.7	12.3	11.9	11.1	10.6	5.1	4.9	
o/w HH sector	8.7	7.1	5.1	4.0	3.7	3.7	3.6	3.5	3.1	3.0	
Return on equity ⁽¹⁾	-5.5	-0.8	2.7	5.5	4.3	1.9	0.3	1.2	2.6	2.8	
Return on assets ⁽¹⁾	-0.3	0.0	0.3	0.6	0.5	0.2	0.1	0.1	0.2	0.2	
Total capital ratio	12.3	15.2	15.2	16.4	16.7	16.7	17.2	17.6	19.0	19.1	
CET 1 ratio	11.4	13.9	13.2	13.9	14.1	14.1	14.6	14.9	15.6	15.8	
Loan to deposit ratio	80.8	78.9	76.2	77.3	76.4	75.7	72.1	73.1	88.6	91.8	

(1) Annualised data

Source: Banco de Portugal and ECB

end-2020. That downtrend noticeably slowed down in the second half of 2020 but it did not reverse. The widespread use of moratoria, covering over 20% of the loan book, state guaranteed loans as well as government support to the private sector have increased demand for new loans. This set of mitigating measures also helped to sustain credit quality. However, the difficult operating environment and the pandemic-induced recession are likely to contribute to a deterioration in asset quality over the coming quarters. A possible increase in defaults is contingent on the length and nature of the pandemic whereas the magnitude of possible NPL inflows will only become clear once the moratoria expire. To prevent a cliff edge when moratoria expire, it is important that banks actively continue to monitor and report borrowers' credit quality, avoiding late recognition of losses.

Consumption expenditure dropped considerably, whereas savings surged, worsening excess liquidity of lenders.

Uncertainty and worries about jobs and personal finances propelled precautionary and forced savings. Suspended monthly redemptions of those who applied for moratoria also swelled deposits. Consequently, the Portuguese savings rate in Q2-2020 was nearly triple of what is normally observed. Deposits with resident banks grew by 10.2% over 2020 and reached the highest level ever recorded. The increase in loan demand was by far not strong enough to absorb this extra liquidity. Thus, the loan-to-deposit ratio fell to new all-time lows. Excess liquidity becomes an increasingly troublesome topic for many Portuguese lenders. Many of them had exceeded liquidity ratios thresholds by a wide margin already long before the crisis. Managing the extra liquidity becomes a challenge both for banks' treasury units facing internal risk management limits on sovereign bonds and from a profitability perspective as many lenders end up depositing their extra liquidity with the ECB at a negative rate. Despite the unwanted additional liquidity, banks remain committed to issue capital instruments in order to comply with their binding MREL targets.

The pandemic cut banks' profitability.

Portuguese lenders barely achieved positive results for 2020 as profits were dented by the swift building up of loan loss provisions. The loan loss charge doubled in 2020, reaching 1% of total gross loans. Most impairments are general impairments

for future defaults based on macroeconomic projections feeding banks' internal risk models. Nevertheless, the cost of credit remains still far below the levels recorded in 2011-2016. Given the array of support measures put in place, including the suspension of the duty to file for insolvency, defaults have remained at low levels so far. Still, stage 2 loans augmented from 9.4% of total loans to 10.6% during 2020. On the revenue side, as interest rates fell further, net intermediation income decreased, despite the positive volume effects from higher loan volumes over the past quarters. The average cost-to-income ratio of the sector decreased to 58% (from 59.2% at end-2019) driven by a slightly bigger drop in operational costs than in total operating income. Branch attendance has not bounced back to pre-pandemic levels. Hence, many banks accelerated branch closures and subsequent staff reductions. Eventually, return on assets (ROA) and return on equity (ROE) fell from 0.5% and 4.9% in 2019 to 0.04% to 0.5% in 2020, respectively.

4.2. POLICY ISSUES

Support measures remain in place, ensuring liquidity and affordable financing while also preserving banks' loss absorption capacity.

The deterioration of the economic situation and the uncertainty about both the magnitude and duration of the pandemic warranted an extension of the measures put in place in the early stage of the pandemic. The banking sector continues to play a critical role in channelling some of the main temporary support measures to the economy, namely credit moratoria and guaranteed credit lines. The main purpose of the extension of the loan moratorium scheme until end-September 2021 is to temporarily mitigate liquidity shortages in light of the delayed recovery in the most affected sectors due to the rebound of infection rates and, consequently, the introduction of new lockdown measures. Given the still high leverage of the Portuguese private sector it is logical that deferrals in servicing loans proved to be a widespread and essential tool to provide liquidity to sectors and individuals heavily impacted by the crisis. By the end of January 2021, approximately 33% of the corporate loan stock remained under moratoria with the sectors most affected by the pandemic (accommodation, food services as well as arts and entertainment activities) having the

highest uptake. Also 16% of the household loan stock benefitted from payment breaks, mainly reflecting the contribution of housing loans. The central bank estimates that the instalments accumulated up to September 2021 will amount to EUR 13 billion, of which 2 billion for private households and 11 billion for companies. The next important instrument to cushion the impact of COVID-19 are government-backed lines of credit, which accounted for about a third of new loans to non-financial corporations between March and December 2020 and 9% of the stock of loans. This support measure was important for local SMEs and sectors heavily impacted by the pandemic allowing firms to access credit on more favourable conditions in terms of both financing cost and maturity.

The pandemic triggered adjustments in macroprudential limits for personal loans. The set of macroprudential recommendations put in place back in July 2018 led to more prudent lending standards and remains appropriate. At the pandemic's onset, Banco de Portugal fine-tuned its macroprudential borrower-based recommendations providing for some flexibility in the economic crisis environment. In particular, personal credit with maturities of up to two years did not have to comply with a debt-service-to-income (DSTI) ratio limit and was also exempted from observing the recommendation of regular principal and interest payments. Increasingly prudent credit standards – ultimately the key purpose of the borrower-based measures enacted in 2018 – have generally been complied with both at the level of the loan-to-value (LTV) and DSTI thresholds. As much as 22% of mortgages preceding the macroprudential measure were attributed with an LTV above 90%. During 2020 that share dropped to just 1% with roughly half of mortgages having a LTV of below 80%. Likewise, around 92% of household loans attributed in 2020 had a DSTI below 50% (the central bank exempted a maximum of 15% of loans being attributed above that threshold). Complying with these limits meant that banks refrained from lending to the riskiest segments, which consequently reduced the loan book's risk weights and augmented the banking system's capital ratio by 74 basis points. However, in 2020 over 2/3 of new mortgages were still granted with maturities above 30 years and the mortgages' initial weighted average remained at 33 years, despite the central bank's recommendation to

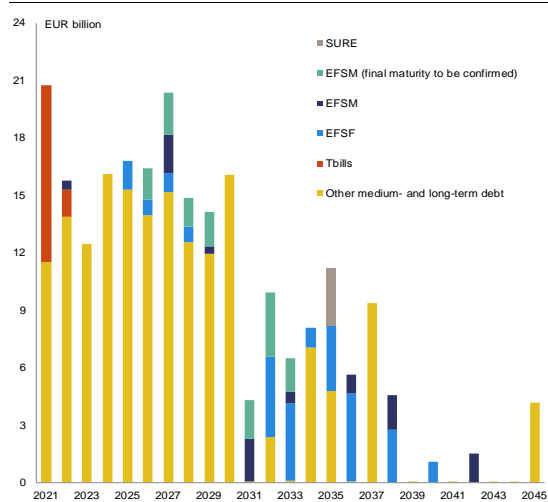
gradually bring down the initial mortgage maturity to 30 years by 2022.

Addressing solvency issues of viable firms remains key. The fall in economic activity over the past year has set an unprecedented challenge to the local corporate sector. Given the still comparatively high financial leverage of Portuguese firms, it rapidly became apparent that an array of various measures was necessary for many businesses to stay afloat. Credit moratoria, the suspension of the duty to file for insolvency and guarantees have mitigated default and insolvency risks. However, for firms that were pushed into heavy financial distress following measures taken to fight the pandemic, allowing timely debt restructuring to continue operations became indispensable. And while deadlines were extended for concluding negotiations initiated under the umbrella of recovery (PER) or payment (PEAP) agreements, the Portuguese authorities established in mid-2020 the extraordinary procedure PEVE (Processo Extraordinário de Viabilização de Empresas). PEVE aims for a simple, fast-track court ratification of a restructuring agreement reached extra judicially between a company and its creditors. PEVE was implemented to enable companies to respond more efficiently to the pandemic and is planned to last until end-2021. Notwithstanding efforts made to avoid a wave of insolvencies, corporate bankruptcies increased by 12.3% year-on-year in the third quarter of 2020 and are forecast to increase further in 2021. The issue of lengthy judicial proceedings (both civil as well as bankruptcy or corporate recovery cases) often dominated by cases lasting over 5 years, the lack of specialised judges in various courts and levels of judicial proceedings still remains and needs to be addressed. This is especially important in the specific context of the current pandemic crisis and once all credit moratoria have expired in Q3-2021. Courts and extrajudicial processes are bound to play an important role in mitigating the effects of the economic crisis both on the corporate sector but also on local banks.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Portugal's debt management strategy has contributed to mitigating vulnerabilities. The Portuguese authorities have deployed continuous efforts to reduce overall annual interest expenditure and cap upcoming annual peaks in the redemption profile of public debt (see Graph 5.1). Financial assistance loans were fully repaid to the IMF by December 2018. In October 2019, Portugal also repaid EUR 2 billion in financial assistance loans to the EFSF – which otherwise were only due in 2025 – without relevant changes to its funding programme. The average residual maturity of Portugal's debt has remained broadly stable at around 7.2 years in 2020. At the outset of the COVID-19 crisis, Portugal managed to diversify its investor base for sovereign debt, thereby regaining interest by some traditional investors, such as banks.

Graph 5.1: Redemption profile of public debt



(1) Last update: 16-03-2021

Source: IGCP

On the back of the COVID-19 pandemic, financing needs surged in 2020, but coincided with a higher cash buffer. In contrast with the recent trend, Portugal's financing needs markedly increased by EUR 5.4 billion (2.7% of GDP), to EUR 24.6 billion in 2020, mainly driven by the worsening of the deficit on a cash basis. That notwithstanding, the fact that the deficit in 2020 ended up being significantly lower than what had been planned at the time of the previous mission (see Section 3.1) – with an ensuing favourable effect on borrowing requirements, at a time when most of the financing had been carried out

already – led to the build-up of a substantial cash buffer of EUR 17 billion (8.5% of GDP) in 2020 (which constitutes around 2/3 of the financing needs expected for the following year). Despite the planned decrease of the deficit on a cash basis in 2021, financing needs are expected to increase further by EUR 1 billion (0.5% of GDP), owing to higher debt redemptions by close to EUR 4 billion (2% of GDP). These debt redemptions are particularly concentrated in the first half of the current year.

The newly-available Support to mitigate Unemployment Risks in an Emergency (SURE) is also visibly easing Portugal's financing terms.

On 25 September 2020, and following the Commission's proposal of 25 August, the Council approved a SURE loan available to Portugal for a maximum of EUR 5.9 billion (3% of GDP).⁽¹⁴⁾ The SURE loan is aimed at supporting Portugal in tackling its heightened financing needs at the current juncture, especially in relation to the sudden and severe increase in public spending on short-time work schemes and similar measures, as well as health-related measures related to the COVID-19 outbreak. On that basis, a first disbursement of EUR 3 billion was carried out on 1 December 2020.

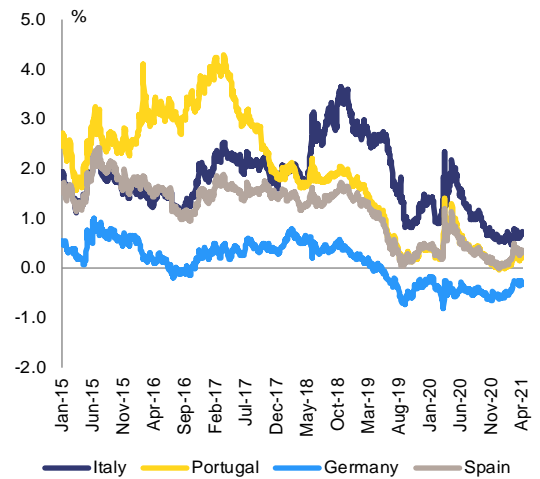
Portugal's high public debt-to-GDP ratio is projected to be on a steady downward path over the medium term, but remains vulnerable to economic shocks. According to the Commission's baseline in the context of the debt sustainability analysis for Portugal, covering the period 2021-2031, the public debt-to-GDP ratio would decline to a still relatively high level of 105% by 2031, thereby exceeding the Treaty reference value of 60% (see Annex 1). Importantly, the projected gradual decrease in the public debt-to-GDP ratio would crucially hinge on attaining structural primary surpluses and favourable GDP growth-interest rate differentials over the medium term. While there are mitigating factors, notably linked to the public debt profile and the substantial cash buffer, the Commission's debt sustainability analysis indicates that Portugal's public debt-to-

⁽¹⁴⁾ Council Implementing Decision (EU) 2020/1354 of 25 September 2020 granting temporary support under Regulation (EU) 2020/672 to the Portuguese Republic to mitigate unemployment risks in the emergency following the COVID-19 outbreak.

GDP ratio is particularly sensitive to any worsening of the country’s economic and financing conditions, or of its fiscal outlook. Furthermore, risks to the pace of public debt reduction are somewhat tilted to the downside, also given the accumulation of public contingent liabilities – on top of non-negligible pre-existing levels – stemming from some public corporations and the private sector, including through the possible calling of public guarantees granted during the COVID-19 crisis.

Portugal’s market financing conditions remained favourable until the cut-off date of this report. Since October 2018, Portugal’s sovereign debt rating has had an “investment” grade by all four relevant rating agencies. Recently, on 19 March 2021, Moody’s confirmed Portugal’s rating at Baa3 with a “positive” outlook. More generally, apart from cuts in the outlook from “positive” to “stable” by Standard & Poor’s, Fitch and DBRS in the course of 2020, the credit rating for Portugal has remained stable since 2019. The accommodative monetary stance in the euro area – especially as a result of the measures taken by the ECB from mid-March 2020 onwards – has helped to contain the yields on government bonds and their ensuing volatility, thereby contributing to the effective transmission of monetary policy. Overall, the implicit interest rate on Portugal’s public debt has decreased steadily since its latest peak at slightly above 4% in 2011. Importantly, it continued to decline to 2.3% in 2020, in spite of the unfavourable pressures exerted by the COVID-19 crisis. Moreover, following a period of heightened volatility that coincided with the sudden outbreak of the COVID-19 pandemic, the yields on Portugal’s 10-year government bonds have returned to pre-crisis levels and remained contained and at historically low levels ever since (Graph 5.2). The gradually declining spreads continue to provide evidence of the convergence of Portugal’s yields with those of its European peers.

Graph 5.2: 10-year government bond yields



Source: European Commission

Sovereign financing and the capacity to repay remain sound. Yields and the absorption capacity of financial markets remain nevertheless vulnerable, due to Portugal’s high public debt-to-GDP ratio and the sudden surge in financing needs triggered by the COVID-19 crisis, thus requiring close and regular monitoring. In the short term, Portugal’s capacity to repay is set to remain sound, with stable and low yields, as well as a solid cash buffer that covers a considerable share of the additional financing needs. In the medium to long term, prudent fiscal policies and fiscal-structural reforms remain key to strengthen the sustainability and resilience of Portugal’s public finances and the country’s capacity to repay.

ANNEX 1

European Commission debt sustainability analysis

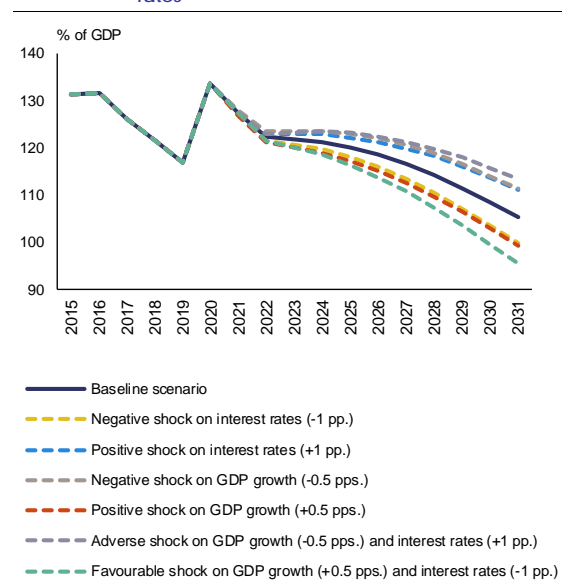
The present debt sustainability analysis (DSA) uses the Commission 2021 spring forecast as a starting point to ensure cross-country consistency and to allow factoring in second-round macroeconomic effects. It covers the period 2021-2031 and includes a few technical assumptions for the medium term.⁽¹⁵⁾ Whilst Portugal's public debt was on a declining path prior to the COVID-19 crisis, the debt-to-GDP ratio reached an all-time high in 2020, soaring by about 17 pps. to 133.6%. A sudden primary deficit and an unfavourable denominator effect drove the observed increase. Mainly thanks to favourable GDP growth-interest rate differentials on the back of the projected improving economic conditions, the public debt-to-GDP ratio is expected to resume a downward path in 2021, when it is set to decline to 127.2%, and to decrease further to 122.3% in 2022. Thereafter, the public debt-to-GDP ratio is projected to remain on a gradually declining path over the 10-year projection horizon. While there are mitigating factors, notably linked to the public debt profile and the substantial cash buffer, the Commission's DSA confirms that Portugal's public debt-to-GDP ratio is particularly sensitive to any worsening of the country's economic and financing conditions, or of its fiscal outlook.

In the short term, Portugal is projected to face high fiscal sustainability risks due to the abrupt and considerable deterioration of public finances in 2020, against the background of the COVID-19 outbreak and the direct budgetary cost of the crisis mitigation measures. In particular, the S0 indicator – which evaluates fiscal sustainability risks in the short term, stemming from the fiscal, macro-financial or competitiveness sides of the

⁽¹⁵⁾ A progressive unwinding of the negative impact on public finances of the COVID-19 crisis is assumed – meaning that the structural primary balance is set to progressively adjust over the projection period, converging back to its pre-crisis forecast level (i.e. the level projected for 2021 in the Commission 2019 autumn forecast). Additional assumptions comprise: (i) a structural primary balance, before ageing costs, of 2.4% of GDP as of 2029; (ii) inflation converging to 2% by 2031; (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 2031; (iv) real GDP growth rates on average slightly below 1% over the period 2023-2031; and, (v) ageing costs in line with the 2021 Ageing Report (European Commission, Institutional Paper 142, November 2020). For more information on the Commission's fiscal sustainability assessment framework, see the Debt Sustainability Monitor 2020 (European Commission, Institutional Paper 143, February 2021).

economy – is above its critical threshold (it is estimated at 0.57, compared with a threshold of 0.46), notably driven by its fiscal sub-index (it is estimated at 0.4, compared with a threshold of 0.36). At the same time, historically low borrowing costs, supported by the Eurosystem's interventions and EU initiatives, have contributed to mitigate the risks. In addition, Portugal's treasury reported an accumulation of currency and deposits by 4.7% of GDP in 2020, while gross financing needs are projected to decline over the forecast horizon.

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



Source: European Commission (based on 2021 spring forecast)

In the medium-term, Portugal is also projected to face high fiscal sustainability risks. The assessment of medium-term fiscal sustainability risks reflects an overall conclusion based on the S1 indicator and the DSA for Portugal. First, the S1 indicator – which evaluates fiscal sustainability risks in the medium term – is below its upper critical threshold (it is estimated at 1.3, compared with an upper threshold of 2.5), thereby indicating medium fiscal sustainability risks in the medium term. In practice, this suggests that a cumulated additional improvement in the structural primary balance by 1.3% of GDP, over 5 years as from the year when the baseline structural primary balance would return to its pre-COVID-19 crisis value (2.4%), compared with the Commission's baseline scenario, would be required to bring the public

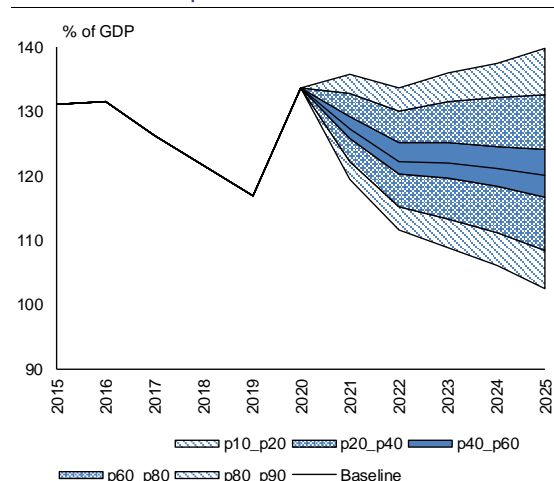
debt-to-GDP ratio down to the Treaty reference value of 60% 15 years after 2029. This relatively high score for the S1 indicator is mainly due to the considerable distance of the public debt-to-GDP ratio from the Treaty reference value of 60%. Second, the Commission’s DSA points to overall high risks based on its baseline scenario and plausible alternative scenarios, which project public debt-to-GDP ratios above 90% by 2031.

In detail, the Commission’s DSA confirms the unfavourable effect of the COVID-19 crisis on Portugal’s public debt ratio developments. This effect is projected to only gradually unwind, resulting in a protracted decline of the public debt-to-GDP ratio over the projection period. According to the Commission’s baseline scenario based on the 2021 spring forecast, the public debt-to-GDP ratio is expected to steadily decline at a gradual pace of about 2.5 pps. per year on average to a relatively high level of 105% by 2031 (see Graph A1.1). Only in 2027 would the public debt-to-GDP ratio reach its pre-crisis level at the end of 2019. Moreover, the projected gradual decrease in Portugal’s public debt-to-GDP ratio would crucially hinge on attaining structural primary surpluses and favourable GDP growth-interest rate differentials over the 10-year projection horizon.

The Commission’s DSA also indicates that the public debt-to-GDP ratio would be sensitive to any worsening of Portugal’s economic and financing conditions. In plausible scenario alternatives to the Commission’s baseline scenario – incorporating potential shortfalls in nominal GDP growth or interest rate hikes – the public debt-to-GDP ratio would still be forecast to remain on a downward path over the 10-year projection horizon, but the pace of debt reduction would be visibly impaired. Public debt sensitivity to shocks is also evident in stochastic extension of the baseline projection based on the historical volatility of the Portuguese economy, which show that public debt projections are surrounded by considerable uncertainty (see Graph A1.2).⁽¹⁶⁾ In such a stochastic extension of

the baseline projection, there is a significant probability of the public debt ratio to be higher in 2025 than in 2020. At the same time, there are mitigating factors, which relate to the relatively stable financing sources (with a diversified and large investors’ base) and the gradual smoothening of the redemption profile of Portugal’s public debt. In addition, the implementation of reforms and investments under Next Generation EU, notably the Recovery and Resilience Facility, is expected to have a substantial positive and long-lasting impact on GDP growth in the coming years, which should contribute to strengthening debt sustainability.

Graph A1.2: Stochastic projections for the public debt ratio in the period 2021-2025



Source: European Commission (based on 2021 spring forecast)

In due course, a refocusing of fiscal policies towards achieving prudent medium-term fiscal positions will contribute to ensuring fiscal sustainability in the medium term. Importantly, were Portugal’s structural primary balance to revert back to its historical trend – that is, to gradually converge to its last 15-year historical average of a structural primary deficit of around ¾ % of GDP – the public debt-to-GDP ratio would decline to about 115%, as much as 10 pps above the Commission’s baseline scenario (see Graph A1.3). In contrast, were Portugal’s structural

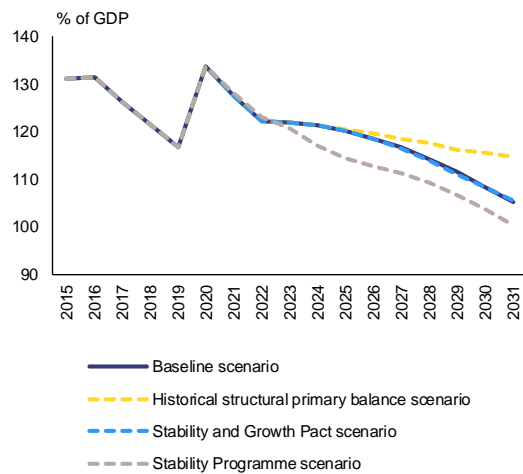
is reported as a solid black line at the centre of the cone. The differently shaded areas within the cone represent different portions of the distribution of possible debt paths. The dark blue area (delimited by the 40th and the 60th percentiles) includes the 20% of all possible debt paths that are closer to the baseline.

⁽¹⁶⁾ Stochastic debt projections allow assessing the uncertainty surrounding macroeconomic and fiscal projections. Projections have a five-year projection horizon. Results are based on 80% of all possible debt paths obtained by simulating 2,000 shocks to the primary balance, nominal growth and interest rates (the lower and upper lines delimiting the cone represent respectively the 10th and the 90th distribution percentiles). In the chart, the projected debt path under the baseline (around which shocks apply)

primary balance to follow the trend underlying its 2021 Stability Programme – which notably entails a less negative budget balance over the medium term – the public debt-to-GDP ratio would decline to about 100%, 5 pps below the Commission’s baseline scenario. At the same time, the medium-term debt position is also affected by budgetary costs stemming from demographic ageing, which are projected to deter the speed of debt reduction by close to 0.5 pps by 2031. Risk-increasing factors are related to public contingent liabilities stemming from some public corporations and the private sector, including through the possible materialisation of state guarantees granted to firms during the COVID-19 crisis.

In the long term, Portugal is projected to face medium fiscal sustainability risks. The S2 indicator – which evaluates fiscal sustainability risks in the long term – is below its lower critical threshold (it is estimated at -4.2, compared with a threshold of 2). However, the assessment of long-term challenges to fiscal sustainability also takes into consideration the conclusion on the country’s DSA, thus leading to an overall conclusion of medium risks in the long term. These risks highlight the need to persevere with prudent fiscal policies and growth-oriented structural reforms to strengthen the sustainability of Portugal’s public debt and enhance economic resilience.

Graph A1.3: Public debt projections under different scenarios for fiscal consolidation



Source: European Commission (based on 2021 spring forecast)

ANNEX 2

European Commission macroeconomic and fiscal projections

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

<i>Annual % change</i>	2019	2020	2021	2022
1. Private consumption expenditure	2.6	-5.9	4.0	3.8
2. Government consumption expenditure	0.7	0.4	2.0	1.7
3. Gross fixed capital formation	5.4	-1.9	4.6	6.9
4. Final domestic demand	2.8	-4.1	3.7	4.0
5. Change in inventories	--	--	--	--
6. Domestic demand	2.8	-4.6	3.8	4.0
7. Exports of goods and services	3.9	-18.7	10.3	8.9
7a. - of which goods	2.9	-7.8	6.1	4.3
7b. - of which services	5.8	-36.8	20.3	18.5
8. Final demand	3.2	-8.9	5.5	5.3
9. Imports of goods and services	4.7	-12.0	9.5	6.0
9a. - of which goods	3.8	-9.5	7.6	4.9
9b. - of which services	8.7	-22.9	18.8	10.6
10. Gross domestic product at market prices	2.5	-7.6	3.9	5.1
<i>Contribution to change in GDP</i>				
11. Final domestic demand	2.7	-4.0	3.8	4.1
12. Change in inventories + net acq. of valuables	0.1	-0.6	0.0	0.0
13. External balance of goods and services	-0.3	-3.0	0.1	1.0

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

<i>Annual % change</i>	2019	2020	2021	2022
1. Private consumption expenditure	3.6	-5.0	5.2	5.5
2. Government consumption expenditure	3.4	5.2	5.8	1.8
3. Gross fixed capital formation	8.0	-0.7	6.0	9.4
4. Final domestic demand	4.3	-2.5	5.5	5.5
5. Change in inventories	--	--	--	--
6. Domestic demand	4.4	-3.1	5.5	5.5
7. Exports of goods and services	4.5	-20.2	11.3	10.2
8. Final demand	4.4	-8.3	7.0	6.8
9. Imports of goods and services	4.7	-15.2	11.4	7.1
10. Gross national income at market prices	4.2	-4.4	5.8	6.2
11. Gross value added at basic prices	4.3	-4.5	5.6	7.0
12. Gross domestic product at market prices	4.3	-5.4	5.4	6.7
Nominal GDP, EUR bn	213.9	202.5	213.3	227.6

Table 3: Implicit price deflators

<i>% change in implicit price deflator</i>	2019	2020	2021	2022
1. Private consumption expenditure	1.0	0.9	1.2	1.6
2. Government consumption expenditure	2.6	4.8	3.8	0.1
3. Gross fixed capital formation	2.5	1.3	1.3	2.4
4. Domestic demand (incl. inventories)	1.5	1.6	1.7	1.5
5. Exports of goods and services	0.5	-1.8	0.9	1.2
6. Final demand	1.2	0.6	1.5	1.4
7. Imports of goods and services	0.0	-3.6	1.7	1.0
8. Gross domestic product at market prices	1.7	2.4	1.4	1.5
HICP	0.3	-0.1	0.9	1.1

Table 4: Labour market and cost

<i>Annual % change</i>	2019	2020	2021	2022
1. Labour productivity (real GDP per employee)	1.7	-5.9	2.9	3.9
2. Compensation of employees per head	3.5	2.9	2.8	2.8
3. Unit labour costs	1.9	8.0	-0.4	-1.3
4. Total population	0.0	0.2	0.1	0.1
5. Population of working age (15-74 years)	0.0	0.2	0.1	0.1
6. Total employment (fulltime equivalent)	0.8	-1.7	1.0	1.2
7. Calculated unemployment rate - Eurostat definition (%)	6.5	6.9	6.8	6.5

Table 5: External balance

<i>levels, EUR bn</i>	2019	2020	2021	2022
1. Exports of goods (fob)	57.9	52.2	56.0	59.1
2. Imports of goods (fob)	74.7	64.8	71.1	75.4
3. Trade balance (goods, fob/fob) (1-2)	-16.8	-12.6	-15.1	-16.3
<i>3a. p.m. (3) as % of GDP</i>	<i>-7.9</i>	<i>-6.2</i>	<i>-7.1</i>	<i>-7.2</i>
4. Exports of services	35.3	22.1	26.7	32.0
5. Imports of services	17.6	13.5	16.1	18.0
6. Services balance (4-5)	17.6	8.6	10.6	14.0
<i>6a. p.m. 6 as % of GDP</i>	<i>8.2</i>	<i>4.2</i>	<i>5.0</i>	<i>6.2</i>
7. External balance of goods & services (3+6)	0.8	-4.0	-4.5	-2.2
<i>7a. p.m. 7 as % of GDP</i>	<i>0.4</i>	<i>-2.0</i>	<i>-2.1</i>	<i>-1.0</i>
8. Balance of primary incomes and current transfers	-0.5	1.8	2.7	1.4
<i>8a. - of which, balance of primary income</i>	<i>-5.4</i>	<i>-3.0</i>	<i>-2.3</i>	<i>-3.7</i>
<i>8b. - of which, net current Transfers</i>	<i>4.9</i>	<i>4.9</i>	<i>5.1</i>	<i>5.1</i>
<i>8c. p.m. 8 as % of GDP</i>	<i>-0.2</i>	<i>0.9</i>	<i>1.3</i>	<i>0.6</i>
9. Current external balance (7+8)	0.3	-2.1	-1.7	-0.8
<i>9a. p.m. 9 as % of GDP</i>	<i>0.2</i>	<i>-1.1</i>	<i>-0.8</i>	<i>-0.4</i>
10. Net capital transactions	1.7	2.4	2.8	3.4
11. Net lending (+)/ net borrowing (-) (9+10)	2.0	0.2	1.1	2.6
<i>11a. p.m. 11 as % of GDP</i>	<i>1.0</i>	<i>0.1</i>	<i>0.5</i>	<i>1.1</i>

Table 6: Fiscal accounts

	2019	2020	2021	2022
% of GDP				
Taxes on production and imports	15.0	14.4	14.2	13.9
Current taxes on income, wealth, etc.	9.7	9.9	9.5	9.4
Social contributions	11.8	12.6	12.3	12.1
Sales and other current revenue	5.7	5.4	6.3	5.5
Total current revenue	42.3	42.4	42.3	40.9
Capital transfers received	0.3	0.4	1.2	1.6
Total revenue	42.6	42.8	43.5	42.4
Compensation of employees	10.7	11.7	11.8	11.5
Intermediate consumption	5.2	5.6	5.6	5.3
Social transfers in kind via market producers	1.9	1.9	1.9	1.9
Social transfers other than in kind	16.2	17.9	17.6	17.0
Social payments	18.1	19.8	19.5	18.9
Interest paid	3.0	2.9	2.6	2.4
Subsidies	0.4	1.8	2.0	0.5
Other current expenditure	2.2	2.6	2.5	2.4
Total current expenditure	39.6	44.3	44.1	41.0
Gross fixed capital formation	1.9	2.2	2.5	3.2
Other capital expenditure	1.0	1.9	1.6	1.6
Other (residual)	3.3	4.5	4.1	4.1
Interest expenditure	3.0	2.9	2.6	2.4
Total expenditure	42.5	48.4	48.2	45.8
General government balance (ESA2010)	0.1	-5.7	-4.7	-3.4
Primary balance	3.0	-2.8	-2.1	-1.0
% change				
Taxes on production and imports	3.6	-9.1	3.5	4.8
Current taxes on income, wealth, etc.	0.8	-3.7	1.3	5.6
Social contributions	5.9	1.2	2.4	4.8
Sales and other current revenue	13.9	-21.1	56.1	-15.5
Total current revenue	4.0	-5.2	5.2	3.1
Capital transfers received	-30.9	19.9	222.8	35.3
Total revenue	3.6	-5.0	7.2	4.0
Compensation of employees	4.0	3.7	6.1	3.8
Intermediate consumption	2.8	1.4	6.4	0.2
Social transfers in kind via market producers	5.0	-1.5	5.7	4.7
Social transfers other than in kind	3.9	4.1	3.7	2.9
Interest paid	-8.3	-8.6	-4.0	-2.5
Social payments	4.0	3.5	3.9	3.1
Subsidies	6.7	321.8	21.4	-74.7
Other current expenditure	2.1	9.2	2.7	4.6
Total current expenditure	2.7	5.9	4.9	-1.0
Gross fixed capital formation	5.9	11.0	20.5	35.6
Other capital expenditure	-8.8	74.3	-13.8	10.6
Total expenditure	2.5	7.8	4.9	1.3
Nominal GDP, EUR bn	213.9	202.5	213.3	227.6

Table 7: Government debt developments

	2019	2020	2021	2022
ESA2010 government balance (% of GDP)	0.1	-5.7	-4.7	-3.4
ESA2010 gross debt (% of GDP)	116.8	133.6	127.2	122.3
ESA2010 government balance	0.2	-11.5	-10.0	-7.7
Gross debt	250.0	270.5	271.4	278.3
Change in gross debt	0.7	20.5	0.9	6.9
Nominal GDP	213.9	202.5	213.3	227.6
Real GDP growth (% change)	2.5	-7.6	3.9	5.1
Change in gross debt (% of GDP)	0.3	10.1	0.4	3.0
Stock-flow adjustments (% of GDP)	0.4	4.5	-4.3	-0.3
Gross debt ratio	116.8	133.6	127.2	122.3
Change in gross debt ratio	-4.6	16.8	-6.4	-5.0
Primary balance	3.0	-2.8	-2.1	-1.0
"Snow-ball" effect	-2.0	9.3	-4.1	-5.5
of which				
<i>Interest expenditure</i>	3.0	2.9	2.6	2.4
<i>Real growth effect</i>	-2.9	9.3	-5.0	-6.1
<i>Inflation effect</i>	-2.0	-2.9	-1.7	-1.8
Stock-flow adjustments	0.4	4.5	-4.3	-0.3
<i>Implicit interest rate</i>	2.5	2.3	2.1	2.0

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