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European Commission
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In-Depth Review 2024

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EUROPEAN ECONOMY

Institutional Paper 285

European Commission

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This in-depth review presents the main findings of the Commission's staff assessment of macroeconomic vulnerabilities for Portugal for the purposes of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances. It provides technical input to the Commission for the Communication "European Semester – 2024 Spring Package" that will set out the Commission's assessment as to the existence of imbalances or excessive imbalances in Portugal. That Communication will be published in June 2024. The current version has been presented and discussed with the Member States in the Economic and Political Committee of the Council.

This publication reproduces staff working document SWD(2024) 105 final, that was discussed with Member States in the Economic and Political Committee of the Council on 18 April 2024.

Contents

1. INTRODUCTION

This in-depth review (IDR) analyses the evolution of Portugal's vulnerabilities related to high private, government and external debt, and possibly newly emerging risks. This year's IDR, which follows the 2024 Alert Mechanism Report (AMR) published in November 2023, assesses the persistence or unwinding of the vulnerabilities identified last year, potential emerging risks, and relevant policy progress and policy options that could be considered for the future ([1]).

The vulnerabilities in Portugal are analysed against the backdrop of economic growth moderation and inflation receding from high levels ([2]). GDP growth moderated from 6.8% in 2022 to 2.3% in 2023. This reflects weaker external demand and a temporary slowdown in domestic demand driven by higher interest rates. Growth is expected to remain subdued at the beginning of 2024 and improve gradually afterwards as the steady increase in employment and wages is set to support domestic demand. Private consumption and investment are set to be the main growth drivers. In full-year terms, the Commission's Winter 2024 Interim Forecast projects growth to be 1.2% in 2024 and 1.8% in 2025, and is therefore set to continue outperforming the euro area average. Inflation meanwhile slowed from 8.1% in 2022 to 5.3% in 2023. This reflects a significant downward correction in energy prices as well as a deceleration in the prices of food and non-energy industrial goods. In the last quarter of 2023, inflation dropped substantially to 2.4% (year-on-year) and is forecast to subside further to 2.3% in 2024 and 1.9% in 2025. Nevertheless, in light of the projected continuous increase in household incomes, core inflation is projected to remain somewhat higher than headline inflation and broadly in line with the euro area. Looking ahead, unexpected external shocks could affect economic growth. As a result, the pace of adjustment of Portugal's private and public debt ratios could slow.

High integration with Spain, Germany and France, makes Portugal prone to spillovers resulting from economic developments in these economies ([3]). The Portuguese economy is highly dependent on imports of Spanish and German goods and services, while Spain, France and Germany are major destinations for Portuguese exports ([4]). The largest shares of total value added in the Portuguese economy, apart from domestic demand, are generated to satisfy demand in Spain and France, while Portuguese demand is mostly satisfied by value added generated in Spain, Germany and France. As Portugal's direct exposures to non-EU partners are low, geopolitical and trade tensions do not appear to pose a risk to its economy.

([1]) European Commission (2023), Alert Mechanism Report 2024, COM (2023) 902 final; and European Commission (2023), Alert Mechanism Report 2024, SWD(2023) 901 final

([2]) Figures for GDP growth and inflation come from the Commission Winter 2024 Interim Forecast (European Economy, Institutional Paper 268). All other forecast data used in the IDR come from the Commission Autumn 2023 Forecast (European Economy, Institutional Paper 258), unless stated otherwise, and all calculations are carried out using these data to ensure the coherence of their various components. The cut-off date for the data for the preparation of this IDR was 19 March 2024. Actual outturn data that have become available after the Autumn and Winter Interim forecasts, and before the cut-off date for the IDR, are used and supersede figures from those forecasts.

([3]) In the context of the multiple disrupting shocks that affected the world economy and the EU in the past few years, Commission Services have run an exercise to estimate the spillovers and the degree of exposures of Member States' economies to various partners and industries, in terms of nominal trade, value-added trade, inflation and financial assets. See European Commission Institutional Paper 2024 (forthcoming) - Economic spillovers and exposures in the EU.

([4]) Spain and Germany account for 31.2% and 10.6% of Portugal's imports respectively, while Spain, France and Germany account for 23.3%, 13.9% and 11% of Portuguese exports respectively.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

In recent years, Portugal has been marked by high but receding private, government and external debt. External sustainability indicators have been improving substantially in recent years, helping reduce associated vulnerabilities. The public debt-to-GDP ratio has been decreasing at a fast pace, after an increase during the pandemic. Corporate and household debt ratios have also been declining substantially in recent years. Vulnerabilities in the non-financial corporate debt structure appear relatively low, in part reflecting substantial declines in the non-performing loans (NPL) ratio. The increase in interest rates for housing loans puts some pressure on households, while house prices continue to increase.

Assessment of the gravity, evolution and prospects of macroeconomic vulnerabilities

External balances

The current account improved substantially in 2023, reflecting favourable terms of trade effects and strong growth in foreign tourism. The current account balance moved from a deficit of 1.1% of GDP in 2022 to a surplus of 1.4% in 2023. This considerable improvement reflects a multiple set of factors related to both price and trade volume effects (Graph 2.2 a). The surplus in 2023 exceeded the pre-pandemic outcome as Portugal had been recording smaller surpluses on its current account until early 2020, when the impact of reduced tourism flows and then higher energy prices turned it into a deficit. The downward price correction in energy import prices, particularly gas and electricity, contributed substantially to the terms of trade gains in 2023. To a lesser extent, food commodities also played a favourable role. Substantial gains were also recorded in the services balance, where foreign tourism receipts benefited from the increase in prices of accommodation and catering, while foreign tourism visits rose above pre-pandemic levels. The current account balance therefore moved above the country-specific fundamental and prudential benchmarks, estimated at 0.1% of GDP and -1% of GDP respectively (Table 2.2).

The current account balance is set to remain in a small surplus. The current account surplus is forecast at 1.1% in 2024 and 0.8% in 2025. The trade balance benefits from structural improvements in the energy balance as the share of renewable energy in the country's power generation increased in recent years, leading to a lower use of natural gas. In 2023 alone, the use of natural gas for power generation dropped by 42%, while electricity generation from renewables increased by 24%, according to data compiled by the country's electricity and gas networks operator REN. As a result, the share of renewables in domestic power generation increased to 71% in 2023 relative to an average of 57% over the previous 5 years. At the same time, the deficit in non-energy goods is expected to widen in light of the projected increase in the import of investment goods.

In the medium and long term, Portugal is projected to further reduce its energy trade deficit. Ongoing projects in the areas of energy efficiency, renewables and industrial decarbonisation, including initiatives financed by the recovery and resilience plan (RRP) and cohesion policy programmes, are expected to further strengthen the country's external position. As the energy balance was a major source of vulnerability for the overall current account balance in the past, particularly during the steep energy price hikes in 2022, the ongoing decarbonisation of the economy is set to reduce the risks to the country's external debt sustainability.

Portugal's net international investment position (NIIP) has continued to improve at a fast pace, and the outlook remains favourable. After a temporary deterioration in 2020 driven by the COVID-19 pandemic, the NIIP improved markedly for a third year in a row from -84% of GDP at the end of 2022 to -72% as of the end of 2023 (Graph 2.2 b). This reflected favourable impacts from the positive balance in the current and capital accounts and nominal GDP growth. Compared to the historical low of -124% of GDP in 2014, the NIIP strengthened by around 50 percentage points, including an improvement of around 30 percentage points in 2021-2023. The structure of Portugal's external liabilities has also improved in recent years. As of the end of 2023, the NENDI (NIIP excluding non-defaultable instruments, e.g. foreign direct investment and portfolio investment equity) came to –20% of GDP, rising from -30% at the end of 2022 and well above its historical low of -82% in 2012. Looking ahead, the NIIP is set to improve above the estimated prudential threshold in the medium term. Risks to the country's external position are mitigated by its favourable NIIP structure, as non-defaultable instruments account for around 70% of NIIP (Box 2.1).

Private sector debt

Private indebtedness continued to decline, reaching the euro area average in 2023. Following a one-off increase in 2020, the share of private debt in GDP returned to a fast-decreasing pace, supported by high nominal economic growth and subdued lending activity in the face of higher interest rates (Graphs 2.2 c and 2.2 d). The debt ratio fell from 141% at the end of 2022 to an estimated 129% (preliminary data) at the end of 2023, marking a substantial improvement from the peak of 211% in 2012. The ratio therefore moved within the indicative MIP threshold of 133% and was broadly on a par with the euro area average. The private debt-to-GDP-ratio is however still above the estimated prudential and fundamental benchmarks for both the corporate and household sectors (see Table 2.2 and Graphs 2.1 c and 2.1 d).

Corporate debt has been declining amid rising profit margins. The corporate debt-to-GDP ratio continued to decline at a fast pace from 80% of GDP at the end of 2022 to an estimated 74% at the end of 2023 (preliminary data), converging towards the euro area average. In parallel, the NPL ratio in the sector dropped from 6.5% at the end of 2022 to 5.9% in September 2023, and the coverage ratio improved from 56.0% to 60.4% over the same period. In addition, corporate profits improved substantially in both 2022 and 2023, as measured by the sectoral data for the gross operating surplus, which mitigated the negative impact from higher interest rates. In 2023, the share of gross operating surplus in gross value added is estimated to have reached 41% in the corporate sector, marking a full recovery from the pre-pandemic period.

Household debt continues to decline, but the large exposure to variable interest rates increases the interest burden. The share of household debt to GDP dropped substantially from 61% in 2022 to an estimated 55% in 2023 (preliminary data). Compared to the disposable income of households, the debt ratio is estimated at 86% in September 2023 against 92% in the euro area, and is on a steady declining trend. The household debt ratio is projected to continue falling (Box 2.1). However, the household debt service burden is challenged by the high share of mortgage loans with variable interest rates. Loans for house purchase make up almost 80% of the total volume of bank loans to households. The cost of borrowing for new loans for house purchase rose from a historical low of 0.8% in early 2022 to above 4% at the beginning of 2024. Despite the marked decrease in the share of mortgages with variable interest rates in recent years, most mortgages are still either with variable interest rates or with mixed rates, generally with a fixed rate for a period of 1 to 5 years, then switching to a variable rate. The high exposure of households to variable interest rates creates a risk for some households in terms of a substantial increase in their debt service burden due to the steep rise in interest rates in 2023 ([5]). Nevertheless, the NPL ratio of households remained stable at 2.3% in September 2023 (1.2% for mortgages), helped by a large set of support measures (Box 2.2).

Housing market

House price growth has slowed, but house prices remain overvalued. In nominal terms, the growth rate of house prices moderated from 12.6% in 2022 to 7.6% (year-on-year) in the third quarter of 2023 (Graph 2.2 e). The deflated house price index, adjusted by the consumption deflator, slowed for the fourth year in a row from 4.8% in 2022 to 2.8% (year-on-year) in the third quarter of 2023, with an average of 2.3% (year-on-year) over January-September 2023. According to Commission estimates, house price overvaluation increased to around 30%, reflecting the strong nominal house price growth over the last year. However, household income grew somewhat faster than house prices during the year. Nevertheless, the borrowing capacity of households declined amid a significant increase in mortgage rates, reducing the house value that households taking out mortgages could afford (Graph 2.2 f). Despite this reduction in the borrowing capacity of households – which was even stronger in 2023 than in 2022 – house prices continued to increase significantly in Portugal, in contrast to most other EU countries. This impacted housing affordability negatively, particularly for vulnerable groups, and the reported housing cost overburden increased.

Despite the strong increase in house prices and the estimated overvaluation in recent years, the large share of cross-border investment in housing mitigates domestic risks. Over the years, a large part of the financing related to the purchase of properties was linked to foreign direct investment or the commercialisation of residential properties as part of booming tourism. As a result, a part of the strong increase in house prices was not driven by domestic factors and is not associated with domestic borrowing. In 2023, only 45% of residential real estate purchases were financed by domestic lending, while 95% of home loans had a loan-to-value ratio of 80% or less. This would mitigate risks for the domestic economy if the strongly overvalued market started falling. In December 2023, the European Systemic Risk Board assessed the residential real estate risk as medium (as per December 2021) amid elevated house price growth.

House price growth is expected to moderate in the short term, but a marked decline in house valuations is unlikely. Interest rates remain elevated despite recent signs of a modest easing in the financing conditions. The projected increase in the real income of households is projected to partly offset the impact of interest costs on housing affordability, along with the adopted government measures in support of vulnerable households. All in all, considering also supply constraints on the housing market, a marked reduction in house prices appears unlikely. In addition, if strong external investment in the housing market continues, there is also the risk that house price growth could continue to be unusually strong, building up risk for the future.

Financial sector

Portuguese banks improved their resilience in 2023 as higher net interest income boosted their profitability, without materially impacting their asset quality. Banks' profit margins

([5]) For example, recently released data from the ECB Household Finance and Consumption Survey suggest that median debt-service-to-income ratios for indebted households in the bottom quintile of the income distribution were 50% in 2020/21. For these households, increases in interest rates may eat into household budgets. At the same time, they make up a relatively small proportion of all households (around 4%).

increased substantially over 2023 as the large share of variable rate loans yielded higher returns on the back of higher Euribor and key ECB interest rates, while deposit costs remained moderate. This further improved banks' return on equity, to 10.6% in the first three quarters of 2023, the highest level since the financial crisis and above the euro area average. Portuguese banks used part of these profits to strengthen their capital positions, increasing their CET1 capital ratio by 104 basis points over the first three quarters of 2023 to 16.4%.

Asset quality remains sound, and banks' NPL ratios declined further. However, downside risks remain. Credit quality did not deteriorate despite the phase-out of pandemic support programmes and the adverse shock from the energy crisis and high inflation. Banks' NPL ratio declined to 2.9% in Q3-2023 after a slight uptick in the first half of 2023 (3.1% in June 2023 vs 3.0% at the end of 2022) and is well below pre-pandemic levels (6.1% at the end of 2019). Banks continued to dispose of NPLs through sales and write-offs and increased their NPL coverage ratio to 56.3% in September 2023, from 51.5% at the end of 2019. Risky (Stage 2) loans remained broadly stable over the first three quarters of 2023, increasing only slightly from 10.3% to 10.6%. Despite these positive developments, downside risks remain. Inflation and higher interest rates are increasing the pressure on the debt-servicing capacity of some borrowers. At the same time, the banking sector maintains significant exposures to residential real estate and domestic sovereign debt.

Public debt

Portugal's public debt-to-GDP ratio is set to continue declining, albeit at a slower pace. Driven by a favourable nominal growth interest rate differential and a primary surplus, its public debt-to-GDP ratio continued to contract to approximately 99% in 2023, down from 112.4% in 2022 (preliminary data). This represents a substantial reduction, well below its peak of 134.9% in 2020. Over the forecast horizon, public debt-to-GDP is projected to further decline, although at a slower pace. The general government balance is expected to register a noticeable surplus in 2023 and still have a broadly balanced position in 2024 and 2025.

Risks to fiscal sustainability are low overall in the short term, high in the medium term, and low in the long term according to the Commission's debt sustainability framework ([6]). The Commission's early detection indicator (S0) does not point to major short-term fiscal risks. Government gross financing needs in 2024 and 2025 are expected to average below 8% of GDP per year. Financial markets' perceptions of sovereign risk are investment grade, as confirmed by the main rating agencies. The debt sustainability analysis shows that under the baseline scenario, the government debt-to-GDP ratio is projected to decline but remain high in the medium term, at around 88% in 2029 and 83% in 2034, and be vulnerable to a worsening of economic and financing conditions (see Box 1 for more on the medium-term risks to fiscal sustainability). Over the long term, the Commission's fiscal gap indicators (S1 and S2) show that the favourable initial budgetary position is important to mitigate or even offset the projected increase in ageing-related costs and the risk stemming from Portugal's high debt level. At the same time, country-specific factors mitigate the fiscal sustainability risks. Among these, Portugal's comfortable cash buffer, the maturity structure of its debt – most of which with fixed rates – relatively stable financing sources and the currency denomination of debt. Portugal's debt management strategy that targets the smoothening of the debt redemption profile is also a mitigating factor. Different factors add certain risks to fiscal

([6]) The results presented here are based on the debt sustainability analysis published in the Debt Sustainability Monitor 2023 (European Commission, Institutional Paper 271), which is based on the Commission's Autumn 2023 Forecast. The Debt Sustainability Monitor also includes information on the methodology of the Commission's fiscal sustainability risk framework.

sustainability. These include state guaranteed credit lines, ongoing requests for a financial rebalancing of public-private partnerships, vulnerabilities in some public corporations and Portugal's negative NIIP.

Box 1: Portugal – Medium-term external, private and government debt projections

This box summarises external and government debt-to-GDP projections for Portugal over the next decade, based on scenario analysis conducted by the Commission. It covers scenarios to take into account different underlying assumptions for external, corporate and household debt stocks, as well as the outcomes of the latest government debt sustainability analysis conducted by the Commission.

Portugal's net international investment position (NIIP) is projected to continue improving at a sound pace under all three scenarios. Under the baseline projections that take the autumn 2023 forecasts as a starting point, the NIIP increases to around -35% of GDP in 2033, comfortably above the prudential threshold but still below the fundamental benchmark (Graph 2.1 a). The NIIP is set to improve under a range of assumptions. The assumptions in Scenario 1 imply a stronger pace of improvement, with the NIIP around -20% of GDP at the end of the projection horizon. The NIIP also improves in Scenario 2, in which economic growth and the trade balance lag behind the baseline assumptions, whereas the interest spread between liabilities and assets increases. Risks to the country's external sustainability are further mitigated by its favourable NIIP structure, as non-defaultable instruments, foreign direct investments and equity account for around two thirds of the NIIP.

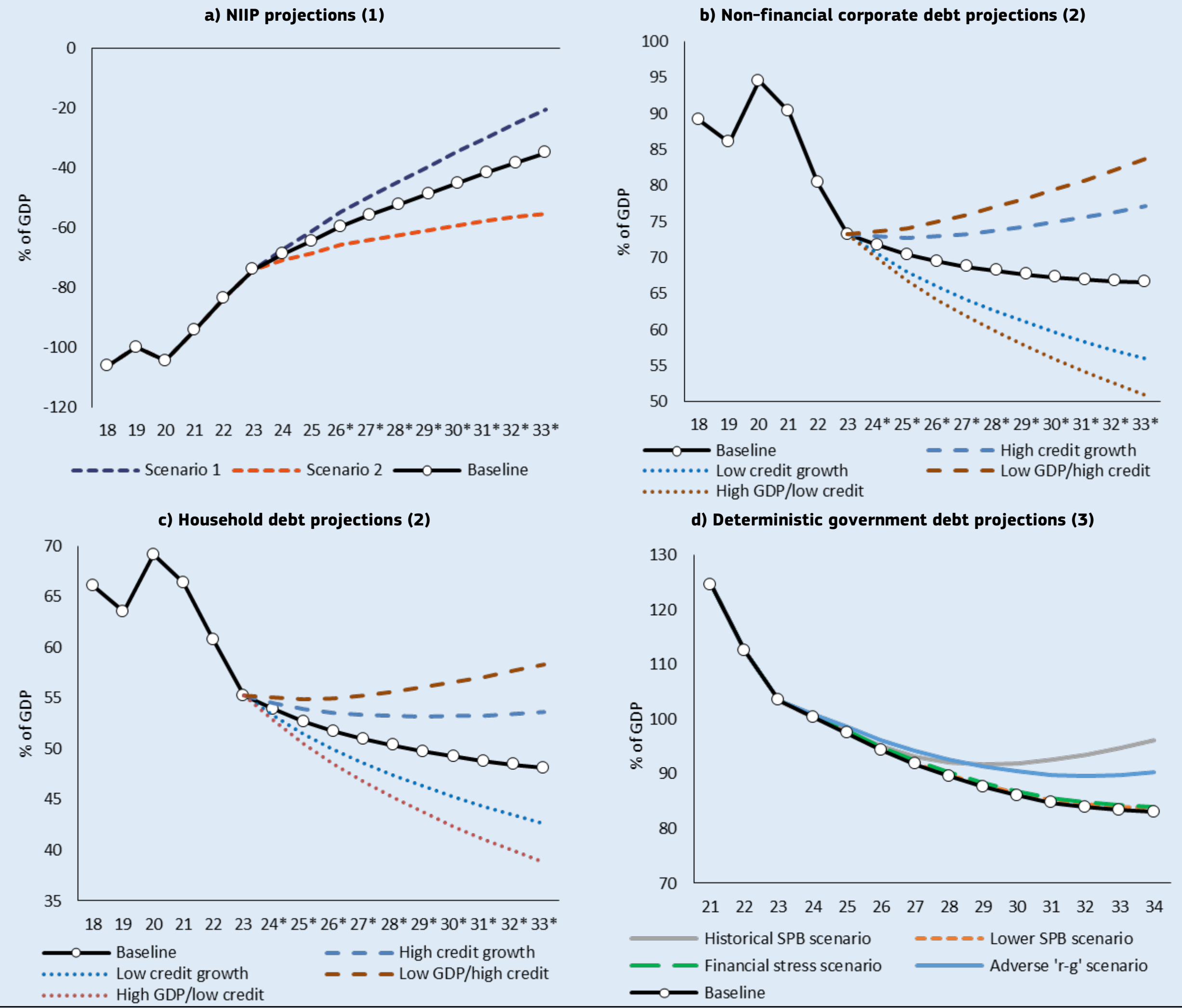
The corporate debt-to-GDP ratio is projected to decrease under the baseline scenario by 7 percentage points until 2033, to 67%. The baseline scenario takes the 2023 forecasts as a starting point and envisages average real GDP growth of 1% in line with Commission projections and credit flows of 1.5% of GDP until 2033 (Graph 2.1 b). In this scenario, credit flows would be below the credit-to-GDP ratio, which would stabilise non-financial corporation (NFC) debt over the projection horizon at 2.3%. Under an adverse scenario of credit flows being 1.2% of GDP higher – corresponding to half the intertercile range of the annualised quarterly credit flow-to-GDP ratio over 2018-2023 – the NFC debt-to-GDP ratio would be 11 percentage points higher. A permanent negative 1% GDP growth shock would increase the NFC debt-to-GDP ratio by another 7 percentage points.

The household debt-to-GDP ratio is projected to gradually decrease over the next decade under the baseline scenario. The baseline scenario takes the 2023 forecast of 55% as a starting point, and assumes as determining parameters average real GDP growth of 1% and credit flows of 0.9% of GDP (solidly below the debt-stabilising credit-to-GDP ratio of 1.7%) for 2024-2033. It projects the household debt ratio to gradually decline to 48% by 2033 (Graph 2.1 c), Depending on how interest rates and other economic conditions evolve, credit flows could also behave differently. Graph 2.1 c considers alternative scenarios on credit flows that have accounted for country-specific variability in credit flows since 2018 and permanent GDP shocks of 1 percentage point above or below the baseline scenario. Under the most adverse scenario (high credit flows and low GDP growth), the debt ratio would rise slightly to 58% by 2033, still solidly below the pre-pandemic level (63%).

In Portugal, medium-term risks to fiscal sustainability are high overall ([7]). The debt sustainability analysis for Portugal shows that, under the baseline scenario, the government debt-to-GDP ratio is projected to decline in the medium term to reach 88% in 2029 and 83% in 2034 (Graph 2.1 d). That projection assumes that, at unchanged policies, the structural primary balance (excluding changes in the cost of ageing) remains at a surplus of 2.1% of GDP between 2024 to 2034. The debt reduction benefits from a still favourable (although declining) snowball effect. Real GDP is expected to grow by 0.9% on average over 2025-2034. Government gross financing needs are expected to average around 8% of GDP per year over 2025-2034. The baseline projections are stress-tested against four alternative deterministic scenarios to assess the impact of changes in key assumptions. All those scenarios would lead to a more rapid increase in debt compared with the baseline. Stochastic projections point to some degree of uncertainty.

([7]) The results presented here are based on the debt sustainability analysis published in the Debt Sustainability Monitor 2023 (European Commission, Institutional Paper 271), which is based on the Commission 2023 autumn forecast. See notes to Graph 2.1 for more details on the four scenarios used.

Graph 2.1: **External, private and government debt projections based on scenario analysis for Portugal**



(1) The baseline NIIP projections are based on Commission's medium-term forecasts for GDP and interest rates. Additionally, assumptions are made about the drawdown of NGEU and MFF funds, and the median value of the last three years is used for non-investment income. Scenario1 assumes higher GDP growth (+1 pp) and the trade balance (+1 pp) than in the baseline from 2024 onwards. Compared to the baseline scenario, Scenario 2 assumes lower GDP growth (-1 pp) and the trade balance (-1 pp) while the interest spread between liabilities and assets is higher by 0.3 pp in each year after 2023.

(2) For the NFC and HH debt projections, the baseline refers to the country-specific median annual credit flow to GDP ratio over 2018-2023. The high/low credit scenario assumes a higher/lower credit flow to GDP ratio, with the difference to the baseline calculated as half the intertercile range of the annualised quarterly credit flow to GDP ratio over 2018Q1-2023Q3. The latter is based on the moving sum of quarterly GDP. The high (low) GDP shock scenario reflects a permanent 1 percentage point increase (decrease) in GDP growth.

(3) The baseline projection is stress-tested against four alternative scenarios to assess the impact of changes in key assumptions: 'historical SPB scenario': the SPB gradually converges to its historical 15-year average; 'adverse 'r-g' scenario': the differential is 1 pp. higher than in the baseline; 'lower SPB scenario': SPB level permanently lower than in the baseline as from 2024; 'financial stress scenario': temporarily increase in market interest rates by 2.4 pps. in 2024.

Source: Eurostat, Ameco, Commission services calculations.

Assessment of MIP-relevant policies

Portugal continued to implement policies that are expected to have a favourable impact on the country's external balance. The main efforts in recent years have focused on the energy sector, where investments in renewables, energy efficiency and savings are reducing the dependency on energy imports and thereby help improve the external balances. As a result of continuous investments, the share of renewables in domestic power generation increased to 71% in 2023 from an average of 57% in the previous 5 years. In terms of installed capacity, the expansion was almost exclusively driven by solar energy with a growth rate of 36% in 2023, according to data from the European network of transmission system operators (ENTSO-e). Portugal also increased its hydro-pumped storage capacity after the inauguration of a new 880 MW facility in July 2022, which was followed by further expansion in January 2024. The full commercialisation of the facility is expected to be completed in 2024. Portugal's continuous efforts in the energy sector are also complemented by the ongoing implementation of the RRP and cohesion policy programmes, where a sizeable share of funding is directed to decarbonisation and energy efficiency and savings. However, there are also some challenges related to the capacity of the electricity grid to accommodate new renewable projects, interconnections with Spain and new labour skills required for the green transition.

Reforms related to digital transformation, the business environment and labour skills are expected to support competitiveness. The authorities continued implementing policies in the field of digital transformation, which are expected to have a positive impact on the country's export potential and competitiveness in the long run. This is complemented by efforts to improve the business environment, including regulated professions, and increase labour skills. However, businesses continue to perceive business regulations and licensing regimes as excessively burdensome. About 83% of firms cite business regulation as a long-term barrier to investment, the highest in the EU ([8]). Similarly, interactions with public administration are seen as complicated and time-consuming, with 77% of businesses citing administrative delays and red tape as an obstacle to operations ([9]). Measures could therefore be considered to further simplify business regulations and licensing regimes. In the context of RRP implementation, progress was made in the areas of the digital transition of businesses, education and public services as well as the enforcement of in-court and out-of-court settlements. Cohesion policy programmes are set to help businesses incorporate new digital technologies, make investments, business qualification, and help small businesses expand abroad.

Portugal progressed in the implementation of programmes aimed at strengthening companies' liquidity and capital, supporting private investment and boosting productivity. The state-owned promotional bank Banco Português de Fomento (BPF) was set up in 2020. Since then, the bank has issued a wide range of funds and guarantee lines to support companies in vulnerable sectors as well as address the issue of undercapitalisation in the Portuguese corporate sector. Under the Portuguese RRP, BPF was recapitalised with EUR 250 million, and two funds managed by BPF were created to provide over EUR 1.43 billion of equity and quasi-equity support to companies by the end of 2025. These measures, together with the capital market reforms implemented in 2023, help develop equity markets in Portugal, promote better management among non-financial corporations and indirectly mitigate risks of insolvencies following the end of most pandemic-related support schemes. The Portuguese RRP also includes several productivity-enhancing measures, such as incentives of over EUR 2.7 billion to support innovative research and innovation agendas. Support from cohesion policy programmes in 2021-2027 is estimated at EUR 5.3 billion, including EUR 1.7 billion for boosting research and innovation. However, investment levels in Portugal remain relatively low as a share of GDP and highly dependent on EU funding, and the use of capital market instruments appears limited. There is therefore still room for policy improvement in the implementation and uptake of capital market instruments.

To address the risks of higher mortgage rates, the government implemented a series of measures to facilitate debt renegotiation and provide direct support to vulnerable households. In continuation of measures adopted in 2022, the government introduced a new package of measures in 2023 to address the risks of a steep increase in interest rates on home loans. The new set of policies aim to smoothen the debt repayment profile by facilitating early repayments and loan renegotiations as well as introducing temporary schemes for direct support to

([8]) EIB Investment Survey 2023.

([9]) The Impact of Regulation on International Investment in Portugal, OECD, 2023.

vulnerable households and reductions in interest payments (Box 2.2). Data provided by INE, Portugal's statistical office, show that the measures helped smoothen the debt burden as the average value of principal repayments declined and partly offset the immediate impact of higher interest rates. In addition, the share of new mortgage loans with variable interest rates fell to 30% by the end of 2023, down from over 90% a decade ago. The government measures came on top of a series of macroprudential measures adopted by the central bank before 2023, along with prudent loan-to-value ratios applied by the banks.

Box 2: Portugal – Policy measures aimed at mitigating the mortgage interest burden

The Council of Ministers approved a new package of measures aimed at mitigating the impact of rising interest rates on mortgages on 21 September 2023. The underlying decree was proclaimed by the President on 9 October 2023 and came into force on 11 October 2023 when it was published in the Portuguese Official Journal. The package includes the three measures below, two of which extend the validity of the measures proclaimed in November 2022 and March 2023.

The suspension of bank charges on early loan repayments is extended until the end of 2024. This measure has been in force since November 2022, but the new decree, which entered into force in 2023, extends its validity from the end of 2023 to the end of 2024. According to data provided by the Finance Ministry, this measure has increased early repayments of housing loans. A total of EUR 6 billion in early repayments was reported from the end of October 2022 to the end of July 2023 (about 4% of total household debt), although the figure includes renegotiated loans of EUR 4.5 billion. The measure is expected to help smoothen the debt redemption profile of households and reduce their overall risk exposure to variable interest rates as the renegotiation process entails a switch from variable to fixed or mixed rates.

The temporary interest subsidy scheme is extended until the end of 2024 and its scope is expanded. The subsidy is directed to households considered more vulnerable to the rise in interest rates. It has been in force since March 2023 (Decree No 20-B/2023). A new decree (No 91/2023 of 11 October 2023) extended its validity from the end of 2023 to the end of 2024. The scope of the measure was also expanded, covering a larger group of potential beneficiaries with variable rate mortgages. Furthermore, access to the subsidy is simplified and the maximum amount is increased from EUR 720.60 to EUR 800 per year. According to estimates from the Finance Ministry, around 900 000 households could be eligible for interest repayment subsidies, covering nearly all variable rate mortgages.

A temporary reduction in interest payments comes into force. The measure provides that for 2 years, interest repayments will be capped at 70% of the 6-month Euribor regardless of the loan contract. The banks can spread the difference relative to the original contract over the remaining loan repayment period while keeping the net present value of the expected flows unchanged. The measure will reduce short-term risks for households from higher interest rates and could potentially smoothen the repayment profile. The measure applies to variable rate mortgages signed before 15 March 2023 with outstanding repayment periods of at least 5 years.

Given the high value of housing loans with variable interest rates in Portugal, the policy intervention appears broadly appropriate. It helps smoothen the housing debt profile and reduces the risk of defaults on housing loans. The measures also provide an opportunity for banks and households to gradually shift towards a larger share of fixed rate mortgages, leading to more balanced risk sharing. The measures are also expected to reduce uncertainty for indebted households, leading to a positive effect on consumer sentiment. On the flip side, the interest rate subsidy covers a large share of variable rate mortgages. This implies that the measure may not be sufficiently targeted at the most vulnerable social groups. Ultimately, the effectiveness of the subsidies will also depend on the degree of enrolment from potential beneficiaries, which might be lower than expected due to various administrative bottlenecks.

The authorities continued to implement measures to improve housing affordability. Further steps were taken to implement the social programme for building 26 000 homes for households in need. Support to housing affordability is also provided by the RRP. In October 2023, the housing market programme (Programa Mais Habitação) also entered into force ([10]). This programme includes

([10]) Law No 56/2023 of 6 October 2023 (published in the Portuguese Official Journal, Diário da República No. 194/2023, first series of 6 October 2023, pp. 2-50).

measures such as the elimination of residence permits for buying property, also known as the Golden Visa programme, fiscal incentives aimed at boosting the housing supply, protection mechanisms for tenants and the promotion of housing for affordable rent. In parallel, the non-habitual tax residents (NHR) regime, under which a tax exemption applies to some foreign incomes and a reduced tax rate applies to some domestic incomes, has been revoked by the 2024 budget law, which is set to reduce demand for properties. Although Portugal has a high ownership ratio of around 80%, there are still certain vulnerable groups facing acute housing problems, which is also borne out by the recent increase in homelessness. A more targeted policy response of providing social support to specific vulnerable groups therefore has the potential to provide a cost-efficient solution to housing affordability.

Macroprudential measures are in place to address financial stability risks related to real estate exposures. These comprise a set of measures introduced since 2018, including measures to limit the maximum loan-to-value (LTV) ratio of new mortgages (90% for own and permanent residence, 80% for other cases). This has helped reduce the average LTV of new mortgages, which was below 80% for 68% of new lending in 2023, and for 95% of the total outstanding stock. Other measures include (i) limits to the debt service-to-income ratio (DSTI), capped at 50% for at least 85% of mortgages; and (ii) a stress indicator for mortgages with variable rates. As of 2023, a macroprudential recommendation limits the average maturity for mortgage-backed loans to 30 years. Banco de Portugal implemented a sectoral Systemic Risk Buffer (SyRB) for real estate exposures to complement the previous borrower-based measures, which will enter into force in October 2024. The latest assessment by the European Systemic Risk Board (ESRB, 2024) considered the risks as medium and the macroprudential policies as appropriate and sufficient.

Relevant steps are being undertaken to address the quality and sustainability of Portugal's public finances, but there is scope for further policy action. Measures in Portugal's RRP will provide the country with a stronger budgetary framework, helping ensure full and effective implementation of the 2015 Budgetary Framework Law, and will promote the country's fiscal sustainability over the medium term. These measures include the development of programme budgeting, the implementation of spending reviews, improvements in centralised procurement and better monitoring and stronger governance of state-owned enterprises. Relevant steps have been undertaken throughout 2023. New procurement models for the national central public procurement system entered into force, a new conceptual model for monitoring the budgetary and financial execution of general government was approved and a report model was introduced for the disclosure of financial information and performance of state-owned enterprises. The modified RRP also includes a new fiscal-structural reform on simplification of the country's tax system, with a focus on reducing the number of tax benefits ([11]). In addition to the RRP, the complexity of the tax system could be further reduced by re-designing the structure of the country's corporate income tax, currently compounded by state and municipal surcharges. On the pension system, demographic ageing coupled with a shrinking working age population is projected to lead to an increase in ageing-related costs. According to the Commission's debt sustainability analysis, these developments pose a challenge to the country's medium-term fiscal sustainability, with risks classified as high.

The implementation of existing commitments in the RRP and possible additional steps could further improve external and public debt sustainability, and private sector deleveraging. Measures to further simplify business regulations and licensing regimes could help improve long-term external sustainability and support corporate sector deleveraging. External

([11]) Council Implementing Decision of 17 October 2023 (ST 13351/23+ADD 1 REV 1) on the approval of the assessment of the modified recovery and resilience plan for Portugal.

sustainability could also benefit from the continued effort, also included in the RRP, to accommodate new renewable projects and improve interconnections, as well as develop the labour skills needed for the green transition. Further support to non-debt investment instruments could be considered to improve access to capital markets and equity financing, particularly for small and medium-sized enterprises. Fiscal sustainability could benefit from a stronger budgetary framework with the effective implementation of the 2015 Budgetary Framework Law, as provided for in the RRP, as well as simplification of the corporate income tax structure and an evaluation of the impact of demographic ageing on the future of the country's pension system. Close monitoring of risks related to high house prices and more targeted social support to vulnerable groups could help address housing affordability concerns, which are also extensively covered in the RRP.

Table 2.1: **MIP-relevant policy progress in Portugal**

Vulnerability	Policies enacted since January 2023	Policies in progress since January 2023
External sustainability	Expanding solar energy capacity and further progress with digitalisation.	Ongoing policy actions are related to energy efficiency, renewables and energy savings.
Private debt	Measures facilitating early debt repayments and loan renegotiations as part of the government package on home loans.	Measures to boost the liquidity and capital of companies, including funding and guarantee lines from the state promotional bank, Banco Português de Fomento (BPF),
Public debt	New models for public procurement and monitoring the budgetary and financial execution of the general government, disclosure of financial information and performance of state-owned enterprises.	Development of programme budgeting and implementation of spending reviews as part of the country's budgetary process.
Housing	New measures to mitigate the mortgage interest rate burden, including direct support to vulnerable households. Adoption of the housing market programme (Programa Mais Habitação).	Macroprudential measures to lower the average maturity of mortgage loans to 30 years and a sectoral systemic risk buffer for real estate exposures, on top of existing measures. Investments in social housing.

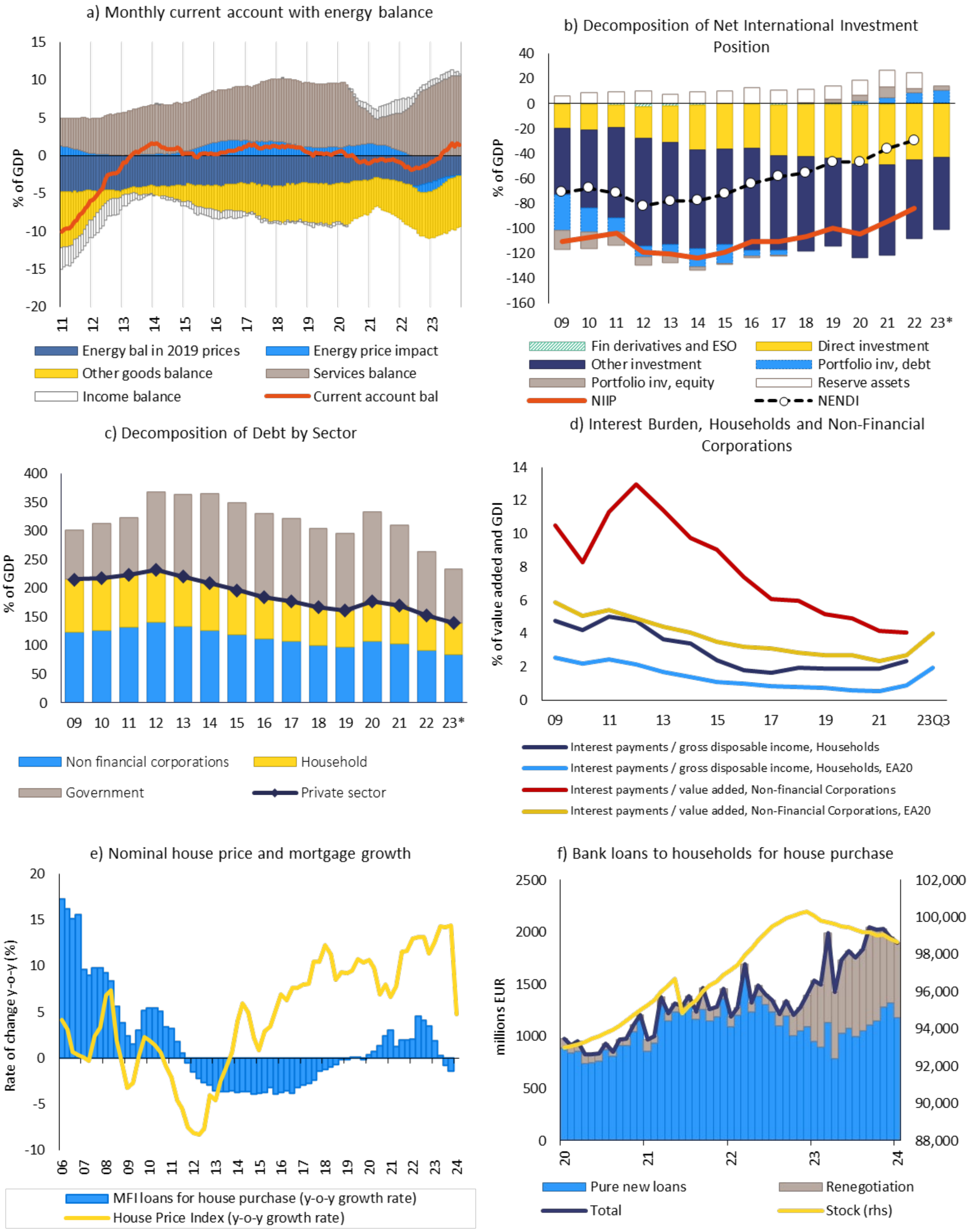
Conclusion

In Portugal, vulnerabilities related to the high level of public, private and external indebtedness continue to recede. The country's external sustainability indicators improved substantially in 2023 as the current balance returned to a surplus, driven by both structural and cyclical factors, with the correction in energy prices playing a role. The negative NIIP-to-GDP ratio improved substantially for a third year in a row, and its structure remained favourable in light of the high share of non-defaultable instruments. Both public and private debt ratios decreased at a fast pace and moved well below their historical peaks. However, Portugal's fiscal sustainability risks are considered high over the medium term and low in the short and long term. Higher mortgage rates in 2023 put some pressure on households, but NPL ratios retained a downward path. Moreover, strong income growth and regulatory measures mitigated the underlying risks. The country's private, public and external indebtedness is projected to continue its favourable trajectory supported by economic growth. While real GDP growth is forecast to weaken temporarily in 2024, nominal GDP is still expected to continue rising at a relatively high rate as domestic demand is set to continue to benefit from RRP grants and loans. The main risks related to the unwinding of macroeconomic vulnerabilities refer to the uncertain external environment and its potential impact on Portugal's economic growth.

Policy progress has been made in response to the identified vulnerabilities, with a particular focus on mitigating risks from higher interest rates. The government adopted a set of measures in 2023 to mitigate the risks from higher mortgage rates. The overall response appears adequate and comes on top of previously enforced macroprudential measures addressing the housing market and housing affordability. The policy response could be further expanded to more targeted support measures for specific vulnerable groups. The ongoing implementation of reforms and investments in the context of Portugal's RRP and cohesion policy programmes is expected to continue having a favourable impact on the growth potential and also contributes to the country's external sustainability, particularly through progress in the areas of energy efficiency, renewables and competitiveness.

On fiscal sustainability, the authorities introduced new models for the public procurement system as well as a new model for monitoring the budgetary and financial execution of the general government and disclosure of financial information and performance of state-owned enterprises. The implementation of fiscal-structural reforms, inside and beyond the RRP, can help strengthen Portugal's medium-term fiscal sustainability. Measures beyond the RRP include simplification of the corporate income tax structure and an evaluation of the impact of demographic ageing on the future of the country's pension system.

Graph 2.2: **Selected graphs, Portugal**



Source: AMECO, ECB, Eurostat and European Commission.

Table 2.2: **Selected economic and financial indicators (Part 1), Portugal**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast 2024	forecast 2025
Real GDP	1.1	-1.4	1.8	-8.3	5.7	6.8	2.3	1.3	1.8
p.m.: Real GDP (Winter 2024 interim Forecast)							*2.3*	*1.2*	*1.8*
Contribution to GDP growth:									
Domestic demand	1.0	-2.8	2.0	-4.9	5.4	4.4	1.8	1.8	2.1
Inventories	0.1	-0.1	0.0	-0.5	0.6	0.1	-0.3	0.0	0.0
Net exports	-0.1	1.5	-0.3	-3.0	-0.2	2.3	0.9	-0.5	-0.3
Output gap (1)	-1.2	-1.6	-0.7	-6.7	-3.3	1.3	1.5	0.7	0.5
Unemployment rate	8.6	12.6	11.3	7.0	6.7	6.2	6.7	6.7	6.6
Harmonised index of consumer prices (HICP)	2.7	1.9	0.6	-0.1	0.9	8.1	5.3	3.2	2.4
p.m.: HICP (Winter 2024 interim Forecast)								*2.3*	*1.9*
HICP excluding energy and unprocessed food (y-o-y)	2.4	1.4	0.7	0.0	0.3	6.2	6.3	3.4	2.7
GDP deflator	3.1	0.6	2.3	2.0	1.9	5.0	7.2	2.9	2.3
External position									
Current account balance (% of GDP), balance of payments	-8.8	-8.0	0.8	-1.0	-0.8	-1.1	1.4	1.1	0.8
Trade balance (% of GDP), balance of payments	-7.5	-5.4	1.3	-1.9	-2.6	-1.9	1.2	.	.
Primary income balance (% of GDP)	-1.9	-3.2	-2.3	-1.4	-0.8	-1.4	-1.8	.	.
Secondary income balance (% of GDP)	0.7	0.6	1.8	2.3	2.6	2.2	2.0	.	.
Current account explained by fundamentals (CA norm, % of GDP) (2)	-1.4	-0.9	-0.3	0.0	-0.2	-0.1	0.1	0.2	0.2
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (3)	-0.5	0.6	-1.0	-1.4	-1.1	-0.6	-0.4	-0.4	0.0
Capital account balance (% of GDP)	1.5	1.5	1.1	1.0	1.7	0.9	.	.	.
Net international investment position (% of GDP)	-73.7	-107.8	-112.9	-104.6	-94.4	-83.6	.	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (4)	-41.3	-71.3	-64.7	-46.7	-36.3	-29.6	.	.	.
Net FDI flows (% of GDP)	0.3	-2.4	-3.0	-2.5	-3.4	-2.3	.	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	1.8	-0.2	0.3	8.7	1.3	0.5	6.5	2.9	2.0
Nominal compensation per employee	3.3	0.4	2.0	1.5	5.1	5.7	8.0	3.7	3.2
Labour productivity (real, hours worked)	1.4	1.1	0.4	0.3	3.0	3.1	1.1	-0.2	0.4
Real effective exchange rate (ULC)	0.1	-1.9	-1.4	3.8	1.0	-2.7	0.1	-0.9	-0.4
Real effective exchange rate (HICP)	1.4	-0.5	-0.3	0.2	-1.6	-1.4	0.9	.	.
Export performance vs. advanced countries (% change over 5 years)	.	-3.4	3.8	-1.5	-2.0	1.8	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	171.2	203.4	172.6	163.7	156.6	141.1	128.1	.	.
Household debt, consolidated (% of GDP)	79.5	90.6	73.8	69.1	66.3	60.7	54.9	.	.
Household debt, fundamental benchmark (% of GDP) (5)	12.1	17.7	28.3	32.6	31.2	31.1	32.3	.	.
Household debt, prudential threshold (% of GDP) (5)	39.1	39.2	36.7	33.6	31.9	29.7	32.6	.	.
Non-financial corporate debt, consolidated (% of GDP)	91.7	112.8	98.8	94.6	90.3	80.4	73.2	.	.
Corporate debt, fundamental benchmark (% of GDP) (5)	40.4	40.1	47.5	53.3	53.3	55.4	58.8	.	.
Corporate debt, prudential threshold (% of GDP) (5)	52.9	53.7	54.5	50.6	48.5	45.6	51.9	.	.
Private credit flow, consolidated (% of GDP)	12.6	4.4	-0.8	4.4	4.5	2.9	0.1 (e)	.	.
Household credit flow, consolidated (% of credit stock)	8.5	0.0	-1.2	1.6	3.4	3.0	.	.	.
Non-financial corporate credit flow, consolidated (% of credit stock)	45.9	28.3	0.3	9.9	7.4	3.4	.	.	.
Net savings rate of households (% of net disposable income)	2.6	1.5	-1.3	2.1	0.4	-4.8	.	.	.

(e) Estimate based on ECB quarterly data.
(1) Deviation of actual output from potential output as % of potential GDP.
(2) Current accounts in line with fundamentals ('current account norms') are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), 'Methodologies for the assessment of current account benchmarks', European Economy, Discussion Paper 86/2018, for details.
(3) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of the Commission's T+10 projections.
(4) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e., foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(5) Fundamental benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds identify a threshold above which banking crises become more likely. The fundamentals-based and the prudential benchmarks are calculated following Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 19.03.2024, where available; European Commission for forecast figures (2023 Autumn Forecast)

Table 2.2: **Selected economic and financial indicators (Part 2), Portugal**

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast 2024	forecast 2025
Housing market									
House price index, nominal	1.5	-1.7	6.2	8.8	9.4	12.6	.	.	.
House price index, deflated	-1.8	-2.9	5.3	8.1	7.3	4.8	.	.	.
Overvaluation gap (%) (6)	-2.1	-4.5	-8.3	12.1	17.2	23.3	28.7	.	.
Price-to-income overvaluation gap (%) (7)	-2.2	-9.9	-8.8	13.9	18.4	23.4	22.8	.	.
Residential investment (% of GDP)	5.8	3.7	2.7	3.4	3.9	3.9	3.7	.	.
Government debt									
General government balance (% of GDP)	-5.0	-7.8	-3.1	-5.8	-2.9	-0.3	0.8	0.1	0.0
General government gross debt (% of GDP)	69.9	101.4	127.3	134.9	124.5	112.4	103.4	100.3	97.2
Banking sector									
Return on equity (%)	13.8	0.3	-4.2	-1.7	4.2	7.7	.	.	.
Common Equity Tier 1 ratio	6.7	8.1	12.6	15.5	14.9	15.6	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (8)	1.2	4.1	10.5	3.9	3.0	2.5	.	.	.
Gross non-performing loans (% of gross loans) (8)	.	.	13.3	4.9	3.6	3.0	2.9	.	.
Cost of borrowing for corporations (%)	5.1	5.6	3.2	2.0	2.0	4.5	5.8	.	.
Cost of borrowing for households for house purchase (%)	4.0	3.6	2.0	0.8	0.8	3.3	4.5	.	.

(6) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation from the long-term average (from 1995 to the latest available year).
(7) Price-to-income overvaluation gap measured as the deviation from the long-term average (from 1995 to the latest available year).
(8) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
Source: Eurostat and ECB as of 19.3.2024, where available; European Commission for forecast figures (2023 Autumn forecast).

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