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Post-Programme Surveillance Report

Portugal, Autumn 2019

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European Commission
Directorate-General for Economic and Financial Affairs

Post-Programme Surveillance Report

Portugal, Autumn 2019

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This report reflects information available up until 6th March 2020.

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(¹) The executive summary of this report was adopted as Commission Communication C(2020)2156 on 2 April 2020. The rest of the report reflects the findings of the Staff Working Document (SWD(2020)58) accompanying this communication.

(²) European Central Bank (ECB) staff participated in this mission, and the drafting of this report, in accordance with the ECB's competences and thus provided expertise on financial sector policies and macro-critical issues, such as headline fiscal targets and sustainability and financing needs.

ABBREVIATIONS

ACE	Allowance for Corporate Equity	MTO	Medium-term Budgetary Objective
BdP	Banco de Portugal	NFCs	Non-financial Corporations
BFL	Budgetary Framework Law	NPLs	Non-performing Loans
CET1	Common Equity Tier 1	OECD	Organisation for Economic Co-operation and Development
CGD	Caixa Geral de Depósitos	PER	Special Revitalisation Process for Enterprises
CIT	Corporate Income Tax	PIT	Personal Income Tax
DBP	Draft Budgetary Plan	PPS	Post-programme Surveillance
DGO	Directorate-General for Budget	PPP	Public-private Partnership
DSA	Debt Sustainability Analysis	q-o-q	Quarter on quarter
EC	European Commission	RoE	Return on Equity
ECB	European Central Bank	RoA	Return on Assets
EDP	Energias de Portugal	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		

EXECUTIVE SUMMARY

This report presents the findings of the eleventh post-programme surveillance (PPS) mission of Commission staff, in liaison with ECB staff, which took place in Lisbon during 11-13 February 2020. Since the conclusion of the tenth post-programme surveillance mission in June 2019, Portugal's economic growth had moderated but remained well above the euro area average. Employment and unemployment rates were already close to their best historical levels although job creation had slowed down. Risks related to the external environment continue to challenge Portugal's export performance.

The outbreak and spread of the Covid-19 coronavirus will have an impact on the economic and fiscal developments in Portugal as in the other EU Member States. The Portuguese government reacted to Covid-19, mainly on 12 March, with a comprehensive package of measures, addressing the immediate health policy challenges and implementing social distancing measures. The package included as well measures to counter the negative economic impact of Covid-19, e.g. guarantee programmes for affected companies and income support measures. The economic and fiscal impact will depend on the duration and the magnitude of disruption at global and regional levels and the related policy response; this could not be quantified by the cut-off date of 6 March 2020 of this report.

Economic growth is estimated at 2.2% in 2019, slowing from a peak of 3.5% in 2017 and 2.6% in 2018. Domestic demand has been the main contributor to growth, supported by buoyant investment and strong, albeit moderating, growth in private consumption. Not yet incorporating the Covid-19 risk, the European Commission Winter forecast of 13 February expected growth at 1.7% in both 2020 and 2021, which was slightly below the estimated potential growth of 1.9%. Based on the data available at the time of the mission, house prices continued to grow at a fast pace, while the stock of household debt to GDP was still decreasing. The labour market was set to continue improving, although at a slower pace. Labour supply had been supported by positive migration flows recently, which helped mitigate existing skill gaps. The main concern related to the recent deterioration in the foreign trade balance, as it implies a slower pace of external adjustment over the forecast period.

Public finances benefited from favourable financing conditions. On the back of strong revenue performance, decreasing interest expenditure and subdued public investment, the headline balance was expected, at the cut-off date, to have improved to a deficit of 0.1% of GDP in 2019, and to turn into a small surplus of 0.1% of GDP in 2020. The structural balance was projected to have improved by 0.1% of GDP in 2019, to a deficit of 0.5% of GDP, and by further 0.2% of GDP in 2020, to a deficit of 0.3% of GDP. Independent of the Covid-19 measures, there were pressures on the expenditure side of the budget, in particular on compensation of employees, as well as on pension and healthcare spending. The high public debt-to-GDP ratio was expected to continue decreasing, reaching 116.7% in 2020, according to the Commission assessment of the Draft Budgetary Plan published on 15 January. According to the 2019 Stability Programme, it was planned to decrease to around 100% by 2023. Fiscal-structural reforms remain key to strengthen expenditure control and cost-efficiency, address the factors contributing to the accumulation of arrears in hospitals during recent years and tackle fragilities in state-owned enterprises. This would create room for growth-friendly spending, notably high-quality public investment.

Financial stability indicators were improving, as economic expansion and cost reductions supported banks' profitability. While there was some heterogeneity among them, banks continued to gradually increase their capital ratios and to repair their balance sheets, with the non-performing loan ratio dropping below 8% in the third quarter 2019. The ratio was expected to further decline but to remain above the average in the euro area. Independent of Covid-19, risks to financial stability remain, partly related to the low interest rate environment, and the Banco de Portugal has recently tightened somewhat its macroprudential recommendation regarding new mortgage and consumer credit.

Sovereign financing and the capacity to repay are sound. Active debt management has smoothed the debt redemption profile and helped reduce interest costs through exchanges of government bonds and early repayments of financial assistance loans. After clearing all liabilities to the IMF by the end of 2018 and completing an early loan repayment of EUR 2 billion to the European Financial Stability Facility in October 2019, debt servicing costs have declined and the redemption profile has improved. Nonetheless, the high public debt-to-GDP ratio implies a risk to the pace of debt reduction.

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1. INTRODUCTION

Staff from the European Commission (EC), in liaison with staff from the European Central Bank (ECB), undertook the eleventh post-programme surveillance (PPS) mission to Portugal between 11 and 13 February 2020. The mission was coordinated with an IMF staff visit. The European Stability Mechanism (ESM) participated in the meetings on aspects related to its own Early Warning System. 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, financial and fiscal developments. Structural reforms in the real sector were analysed only in their macroeconomic context. An extensive assessment of these policies is presented in the European Semester Country Report. The objective is to minimise overlaps with work and reporting in the framework of the European Semester.

The outbreak and spread of the Covid-19 coronavirus will have an impact on the economic and fiscal developments in Portugal as in the other EU Member States. The Portuguese government reacted to Covid-19, mainly on 12 March, with a comprehensive package of measures, addressing the immediate health policy challenges and implementing social distancing measures. The package included as well measures to counter the negative economic impact of Covid-19, e.g. guarantee programmes for affected companies and income support measures. The economic and fiscal impact will depend on the duration and the magnitude of disruption at global and regional levels and the related policy response; this could not be quantified by the cut-off date of 6 March 2020 of this report.

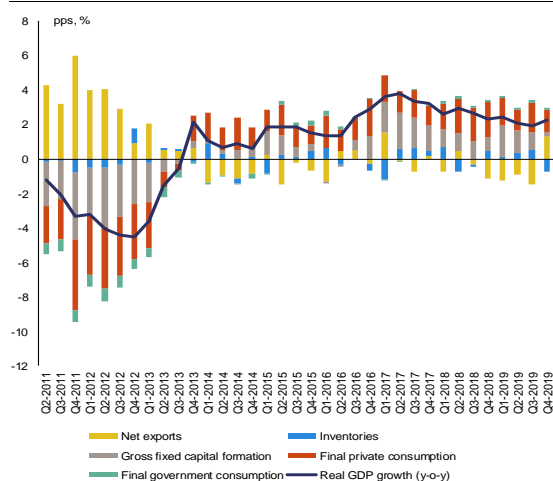
⁽³⁾ PPS is foreseen by Article 14 of the two-pack Regulation (EU) N°472/2013. It started after the expiry of the EU/IMF financial assistance programme and lasts at least until 75% of the financial assistance has been repaid, which is expected in 2035.

2. ECONOMIC DEVELOPMENTS

2.1. MACROECONOMIC SITUATION AND OUTLOOK

Portugal's GDP growth moderated from 2.6% in 2018 to 2.2% in 2019. Domestic demand remained the main contributor to growth, supported by buoyant investment and strong, albeit moderating, growth in private consumption. The contribution of net exports remained negative due mainly to weaker external demand. Apart from external factors, this slowdown represents a gradual convergence towards potential growth, which has been estimated at 1.8% in 2018 and 1.9% in both 2020 and 2021, at the cut-off date of this report. In quarterly terms, the main slowdown took place in the summer months when GDP growth slid to 1.9% y-o-y in Q3-2019. It rebounded to 2.2% y-o-y in Q4-2019, as exports of both goods and services improved. On the supply side, construction was the fastest growing sector throughout the year. The agriculture and service sectors also supported growth while industry contracted on a full-year basis but started to recover towards the end of the year.

Graph 2.1: Contributions to real GDP growth

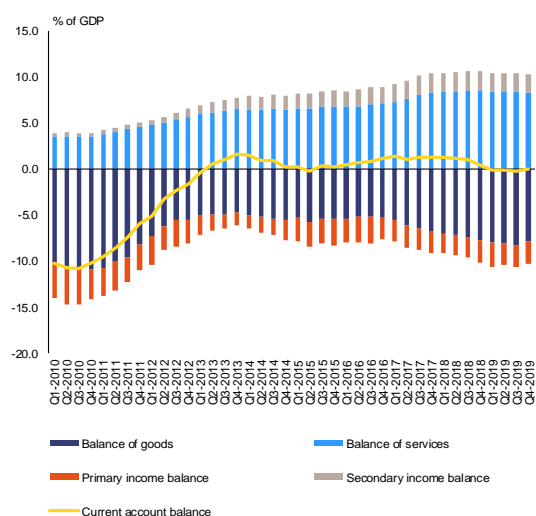


Source: INE

Economic growth has been projected at 1.7% in both 2020 and 2021, albeit subject to significant downside risks, in line with the Commission Winter forecast of 13 February. Growth was expected to moderate again at the beginning of 2020 in light of the fluctuations in global trade and economic sentiments. On a full-year basis, growth

was projected to flatten at 1.7% in both 2020 and 2021, moving slightly below the estimated potential growth. This would imply a gradual reduction in the country's positive output gap. Nevertheless, growth was expected to stay around the median rate in the EU and to exceed the EU average, driven mainly by domestic demand. Although exports were projected to increase slightly faster than GDP, the contribution of net exports to growth was set to remain negative. The balance of risks is tilted to the downside due to the uncertain external environment, particularly with the outbreak of the Covid-19 coronavirus, which will have an impact on the economic and fiscal developments in Portugal as in the other EU Member States. However, its impact will depend on the duration and the magnitude of disruption at global and regional levels and the related policy response; this could not be quantified by the cut-off date of 6 March 2020 of this report.

Graph 2.2: Current account balance



Source: Banco de Portugal

The current account (CA) moved to a deficit of 0.1% of GDP in 2019 relative to a surplus of 0.4% a year earlier, according to balance of payments data. The deficit was linked to the strong increase in imports of investment goods (equipment) in the first quarter of the year. The pace of deterioration moderated afterwards and reversed to positive dynamics in the last quarter of the year when exports grew much faster than imports. Part of the improvement in the last quarter of the year was linked to temporary factors,

including the operational cycles in the car and oil industries, as well as the volatility in the imports of investment goods. Tourism revenues also re-accelerated in y-o-y terms towards the end of the year, as capacity constraints and competition from other destinations were more pronounced in the summer months.

The net international investment position (NIIP) improved from -106.1% of GDP at the end of 2018 to -100.8% of GDP at the end of 2019. However, the pace of adjustment was projected to slow down in 2020-2021 and needs to be monitored, as the CA deficit was forecast to gradually increase to around 1% of GDP until 2021 at the cut-off date of this report. This was largely related to the uncertain external environment underpinning the demand-driven growth over the forecast period. The overall balance of the current and capital accounts was expected to remain slightly positive.

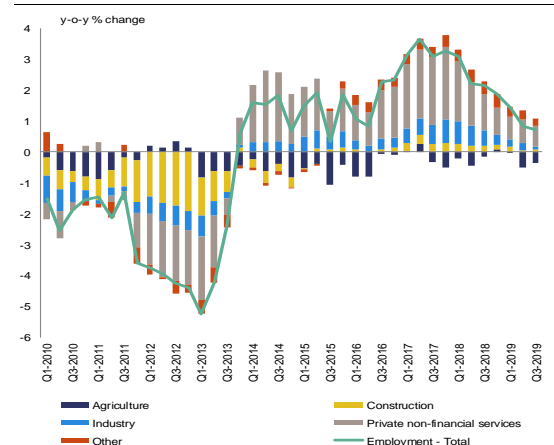
The unemployment rate declined from an annual average of 7.0% in 2018 to 6.5% in 2019. Job creation slowed in the second half of 2019 due mainly to the negative changes in the agricultural sector. The unemployment rate even rebounded to 6.7% at the end of the year, according to data derived from monthly surveys covering the 15-74 age group. However, this rebound was mainly due to the increase in the labour force. Employment grew broadly in line with expectations by 0.9% in 2019, slowing to 0.6% in the last quarter of the year. The employment rate for the 15-74 age group reached 62.4% in 2019 on par with the highest historical level reached in 2001.

Migration continued to support labour supply. Despite the ageing and the negative natural rate of change in the population, the labour surveys showed that the working age population remained stable in 2019. This reflects a positive net migration to the tune of 0.2-0.3% of the working age population. Although this is a small share, it helped mitigate labour supply constraints and offset part of the wage pressures. According to an analysis of Banco de Portugal, about half of the immigrants are Portuguese returning to the country and a substantial part of the remaining half are from Portuguese speaking countries, mainly Brazil. Moreover, the foreign residents have a higher employment and participation rate, higher

educational attainment and a lower median age than Portuguese nationals⁽⁴⁾.

Unemployment was forecast to decline at a slower pace in 2020-2021 at the cut-off date of this report, driven mainly by labour demand in services and construction. Labour supply was expected to benefit from a slightly positive flow of net migration and the activity rate was also projected to improve slightly helped by active labour market policies. These developments were set to improve somewhat the growth in labour productivity and to weaken the growth in unit labour costs. Wage growth was projected to remain stable at around 3% in both 2020 and 2021, reflecting the reduced slack on the labour market and the impact of the minimum wage hike in 2020 along with the career progressions in the public sector.

Graph 2.3: **Employment evolution by sectors**



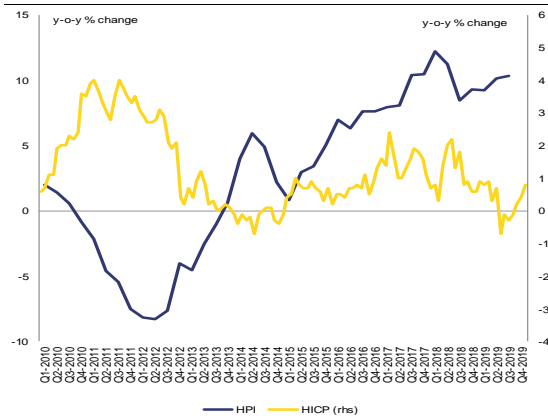
Source: Eurostat

Despite the wage growth and strong domestic demand, inflation remained well below the euro area average. The headline inflation (HICP) dropped from 1.2% in 2018 to 0.3% in 2019 as compared to 1.2% for the euro area. This downturn largely reflected the decrease in energy prices, mainly oil prices, and the negative impact of regulatory changes affecting electricity bills. Furthermore, non-energy prices slowed down due to a significant deceleration in the prices of tourism-related activities, in particular accommodation prices, and a number of legislative measures, such as the reduction in higher

⁽⁴⁾ The migration analysis of Banco de Portugal is presented in its October 2019 Economic Bulletin.

education tuition fees, the increase in subsidies to public transport and the application of the EU regulation limiting the prices of mobile telecommunication services. Core inflation, which excludes energy and unprocessed food, was 0.4%, only marginally above the headline rate in 2019. Taking into account the gradual phase-out of the effects of the aforementioned regulatory changes and legislative measures, as well as the expected wage growth, headline inflation was projected to increase to 1.0% in 2020 and 1.3% in 2021 at the cut-off date of this report.

Graph 2.4: HICP and House price index



Source: Eurostat

House prices kept rising at a fast pace. House prices grew by 10.3% (y-o-y) in Q3-2019, with price growth of new dwellings accelerating to 9.3% (y-o-y) from the annual average of 7.5% in 2018 and price increases of existing dwellings slightly slowing down to 10.6% from 11.0% in the corresponding periods. The increase in house prices, which started as a correction from previously low levels of valuation, has resulted in historically high price levels. At the same time, the share of household debt to GDP was still decreasing albeit from a high level. Overall, the house price level was not considered an imbalance but warrants close monitoring⁽⁵⁾. The number of permits and completions of new buildings maintained the recovery path and the difference between permits and completions remained positive, indicating a future increase in supply. Yet, in light of the increasing use of residential

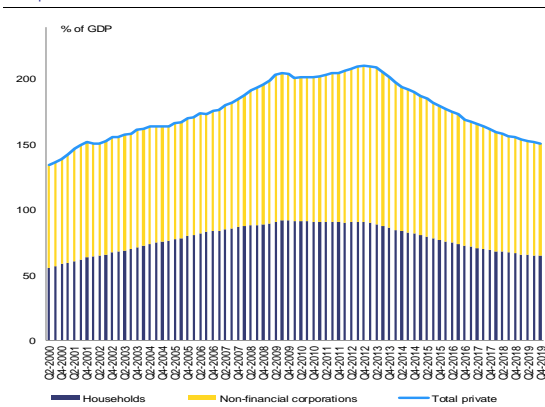
⁽⁵⁾ A detailed assessment of house prices is presented in the Commission’s 2020 Country Report for Portugal – https://ec.europa.eu/info/sites/info/files/2020-european_semester_country-report-portugal_en.pdf

properties for short-term commercial rents, it was seen as unlikely to fully catch up with demand in the short term. The authorities have meanwhile passed amendments to existing incentives to external demand for properties, including the “Golden Visa” programme. The aim is to exclude Lisbon and Porto from the scope of the programme in order to avoid excess demand in the areas most affected by housing affordability problems. However, the measures are not enforced yet and their implementation may be delayed to 2021.

2.2. PRIVATE DEBT

Private debt continued to decline. Consolidated private debt dropped from 155.1% of GDP at the end of 2018 to a preliminary estimate of around 150% at the end of 2019. Corporate debt accounted for about 57% of the total. Both households and non-financial corporations contributed to the decrease in the debt ratio. In absolute terms, the debt stock remained rather flat and the drop in the ratios reflected the increase in nominal GDP. This pattern of passive deleveraging was expected to continue over the medium term with a possible slowdown of the pace, particularly in the household sector where consumer loans were expected to rise.

Graph 2.5: Private indebtedness



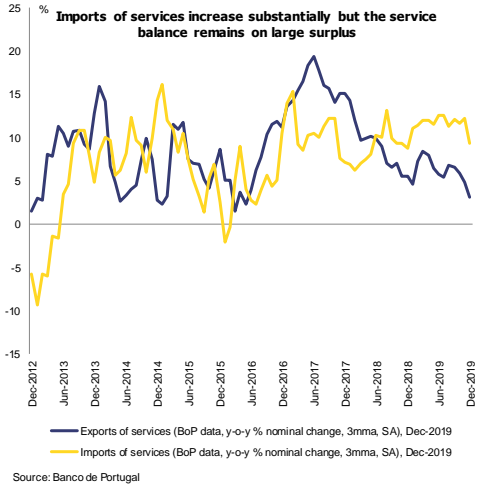
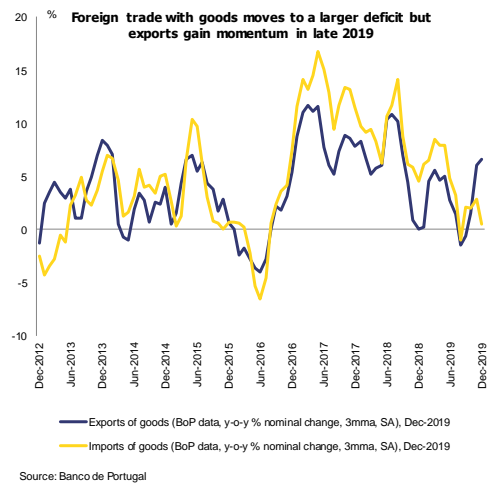
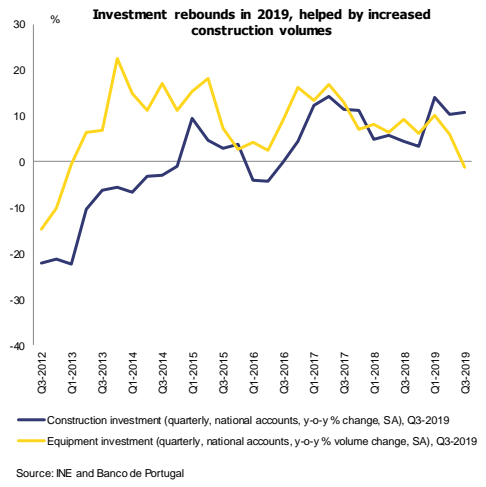
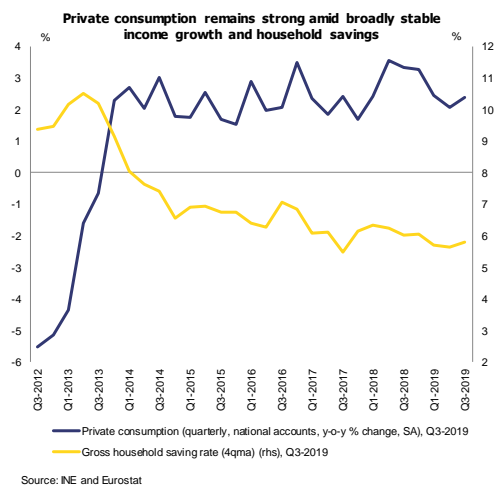
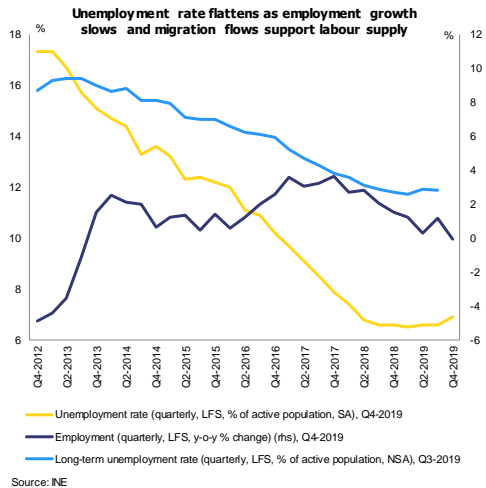
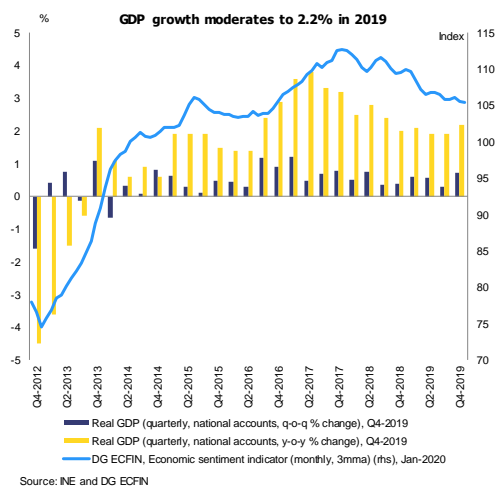
Source: Banco de Portugal

Lending to real estate services was rising. The breakdown of corporate debt by sectors shows that the stock of credit to real estate companies increased from 13.7% of GDP at the end of 2018 to 16.7% at the end of 2019, according to non-consolidated data reported by Banco de Portugal. Across other sectors, small increases were reported

in manufacturing and professional services while the ratios in all other sectors declined. The breakdown by the size of corporate borrowers

shows an increase in the debt ratio for small firms and a decrease in the groups of micro, medium and large firms.

Graph 2.6: Economic developments



Source: European Commission

3. PUBLIC FINANCES

3.1. FISCAL PERFORMANCE AND OUTLOOK

Public finances benefited from the resilient domestic demand and favourable conditions for sovereign financing. According to the Commission's forecast done for the assessment of the Portuguese Draft Budgetary Plan of 15 January⁽⁶⁾ the headline deficit was projected to have decreased from 0.4% of GDP in 2018, to a small deficit of 0.1% of GDP in 2019, helped by strong revenue performance (especially in social contributions) and continuously decreasing interest expenditure. Also, despite its expected increase, public investment likely remained subdued in 2019 (at around 1.9% of GDP, compared with 2.3% in the government budget for 2019, as well as the projection of 3% for the EU as whole). The structural balance was projected to have improved by 0.1% of GDP in 2019, mainly reflecting a further decline in interest expenditure and revenue buoyancy, to a deficit of 0.5% of GDP, despite the structural primary balance being expected to have deteriorated by 0.2% of GDP, to a surplus of 2.6% of GDP last year. On a cash basis, however, the preliminary budgetary execution in 2019 turned out better – by 0.2% of GDP – than the government's projections underpinning the government budget for 2020; this constitutes an upside risk to the headline balance in national accounts for 2019.⁽⁷⁾

The government budget for 2020 includes fiscal policy measures of a structural nature. On the revenue side, the structural measures planned for 2020 implied a marginally negative budgetary impact. These notably reflect selective parametric decreases in the main taxes (Personal and Corporate Income Tax, as well as Value-added Tax), a reduction in university fees and the removal of user charges for primary care, which

were planned to be roughly offset by increases in stamp duty and tax measures to incentivise decarbonisation. These measures could strengthen demand but their impact remains to be determined.

On the expenditure side the structural measures planned for 2020 implied a considerable negative budgetary impact of 0.5% of GDP, even though they mainly reflect the carry-over effect of past measures. The most sizeable negative budgetary impact (of -0.3% of GDP) pertained to the ongoing process of unfreezing of careers in the public service, coupled with additional revisions to careers and an across-the-board increase in public wages. Other measures were planned to increase social transfers (by 0.2% of GDP), including another special increase to low pensions – above the reference for regular pension indexation linked to inflation and real GDP growth – the ongoing early retirement reforms for long careers, updates to some social benefits and the programme envisaging the reduction of public transport prices. The negative budgetary impact of those measures was planned to be partly offset by efficiency gains (of 0.1% of GDP) from the ongoing bottom-up review of public expenditure. In addition, the one-offs planned in the government budget for 2020 included, among others, the recovery of part of the guarantee granted to *Banco Privado Português* (of 0.1% of GDP), on the one hand, and a new activation of the *Novo Banco's* contingent capital mechanism (by 0.3% of GDP), on the other hand.

According to the Commission's forecast, the headline and structural balances were expected to gradually improve in 2020 and 2021. The Commission's forecast projected the headline balance to improve to a small surplus of 0.1% of GDP in 2020. At the same time, the headline balance net of one-offs was set to improve to a surplus of 0.5% of GDP in 2020. Looking ahead into 2021, the headline balance was expected to turn into a surplus of 0.7% of GDP; this already included a major positive one-off impact, corresponding to the recovery of the prepaid margin on the financial assistance loans by the European Financial Stability Facility (EFSF), amounting to 0.4% of GDP. Mostly thanks to further savings in interest expenditure, the structural balance was projected to improve by 0.2% of GDP in 2020, to a deficit of 0.3% of GDP. It was projected to remain broadly unchanged in

⁽⁶⁾ To assess the updated Draft Budgetary Plan for 2020, submitted by Portugal on 17 December 2019, the Commission produced an ad-hoc forecast, in particular by updating its 2019 autumn forecast to take into account the information in that Plan. Unless stated otherwise, the budgetary projections in this report correspond to this forecast and do not reflect data made available afterwards.

⁽⁷⁾ In national accounts, the headline balance of year t is influenced by tax collection in January and February of year $t+1$. Hence, its preliminary value is only notified by Statistics Portugal and validated by Eurostat in the context of the 1st notification of budgetary data for year t under the Excessive Deficit Procedure, in spring of year $t+1$.

Table 3.1: Fiscal adjustment 2011-2021

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Budget balance	-7.7	-6.2	-5.1	-7.4	-4.4	-1.9	-3.0	-0.4	-0.1	0.1	0.7
Budget balance, net of one-offs	-7.5	-6.1	-5.4	-3.5	-3.2	-2.3	-0.9	0.2	0.4	0.5	0.4
Structural balance	-6.7	-3.7	-2.9	-1.6	-2.0	-1.7	-1.4	-0.6	-0.5	-0.3	-0.3
Primary balance	-3.3	-1.3	-0.3	-2.5	0.1	2.3	0.8	2.9	3.0	3.0	3.4
Structural primary balance	-2.4	1.1	1.9	3.3	2.6	2.5	2.4	2.8	2.6	2.6	2.4
Fiscal adjustment	5.8	3.5	0.7	1.4	-0.7	-0.1	-0.1	0.4	-0.1	0.0	-0.2
Fiscal effort	4.5	3.0	0.8	1.4	-0.4	0.3	0.3	0.8	0.1	0.2	0.0

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

Source: European Commission 2019 ad-hoc forecast

2021. Risks to the fiscal outlook were tilted to the downside and associated with uncertainties surrounding the macroeconomic outlook, growing pressures on the main items of current public expenditure and the potentially more negative budgetary impact of bank support measures, compared with the assumptions underlying the government budget for 2020.

The public debt-to-GDP ratio was projected to continue on its gradual downward path, albeit at a slower pace. After falling by 4.1 pps y-o-y to 121.9% in 2018, according to the Commission's forecast, the public debt-to-GDP ratio was projected to have declined further to 119.2% in 2019. That notwithstanding, the preliminary data for the level of public debt in euro terms in December 2019, published in early March 2020, suggest that the public debt-to-GDP ratio (at around 117.7%) has turned out below both the Commission's forecast and the government's own projections. Based on the Commission's forecast, the public debt-to-GDP ratio was expected to continue declining to 116.7% in 2020 and to 113.7% in 2021, mainly thanks to continuous primary surpluses and favourable growth-interest rate differentials, whereby the debt-reducing effect stemming from nominal GDP growth was projected to offset the interest burden on the high debt load. The projected lower pace of decrease of the public debt-to-GDP ratio in 2020 was mostly due to another sizeable stock-flow adjustment, while the acceleration in 2021 reflected the expected higher primary surplus thanks to the aforementioned major positive one-off impact.

3.2. POLICY ISSUES

The public debt-to-GDP ratio decreased at a satisfactory pace. In 2019, Portugal was projected to have made sufficient progress towards

compliance with the debt reduction benchmark of the Stability and Growth Pact (SGP), albeit to a large extent relying on economic growth above potential and favourable financing conditions. In 2020, Portugal was expected to comply with the debt reduction benchmark. According to the 2019 Stability Programme, the public debt-to-GDP ratio was planned to decrease to around 100% by 2023.

Strong growth in public expenditure nevertheless poses risks to compliance with the Council recommendations under the preventive arm of the SGP. In 2019, an overall assessment of compliance based on the Commission's forecast points to a risk of significant deviation from the recommended structural adjustment path towards the relevant MTO – a structural surplus of 0.25% of GDP – partly due to net primary government expenditure being projected to have grown significantly above the applicable benchmark. In 2020, the (recalculated) structural deficit⁽⁸⁾ of 0.2% of GDP in Portugal's updated Draft Budgetary Plan was close to the relevant MTO – a balanced budgetary position in structural terms. The Commission's forecast of a structural deficit of 0.3% of GDP in 2020 was however slightly more distant from the MTO and could therefore not be considered close to it. Hence, an overall assessment of compliance based on the Commission's forecast also pointed to a risk of significant deviation from the recommended structural adjustment path towards the MTO in 2020, in view of net primary government expenditure having been again projected to grow significantly above the applicable benchmark this year. Overall, while the MTO was within reach in 2020, the fact that the growth of net primary

⁽⁸⁾ Cyclically adjusted balance net of one-offs and temporary measures, recalculated by the Commission on the basis of Portugal's updated Draft Budgetary Plan for 2020 using the commonly agreed methodology.

government expenditure was set to exceed what was recommended by the Council remained a source of concern, leading the Commission to conclude that Portugal's Draft Budgetary Plan for 2020 was at risk of non-compliance.⁽⁹⁾

Growing pressures on the most sizeable items of current public expenditure remained somewhat unattended. The gradual unfreezing of careers in the public sector and the continuously accelerating growth of the public workforce (2.2% y-o-y in the fourth quarter of 2019) – which was nevertheless magnified by the still ongoing wide-ranging programme in the public sector to convert temporary contracts into permanent ones – were exerting increased pressure on compensation of employees. Moreover, recurrent increases to low pensions – above the reference for regular pension indexation – and the sequential broadening of pathways to early retirement have entailed further increases in pension spending on top of the underlying upward trend driven by demographic ageing. At the same time, the bottom-up review of public expenditure aimed at improving the efficiency of public spending in some areas, that was initiated in 2016, is a step in the right direction but has progressed slowly and generated so far modest budgetary savings, while efficiency gains are not systematically assessed. According to Portugal's updated Draft Budgetary Plan for 2020, it was planned to lose some momentum this year, when it was expected to generate more limited budgetary savings of EUR 190 million, compared with EUR 236 million in 2019. Furthermore, an ex-post assessment of the savings achieved between 2016 and 2019 is neither known nor planned. On balance, the planned efficiency gains risk falling short of offsetting the aforementioned accelerating pressures on current public expenditure. On the positive side, the authorities committed to improving their capacity to evaluate the impact of the ongoing review of public expenditure on the efficiency of public spending.

Stronger framework conditions for fiscal policy could contribute to a more growth-friendly path for fiscal policy. If effectively implemented, the 2015 Budgetary Framework Law (BFL) could contribute to the upgrade of Portugal's fiscal framework, including through a stronger medium-

term focus of fiscal policy and the introduction of programme budgeting (i.e. the preparation of specific budgets for each of the government's public policies, highlighting therein the ensuing costs and sources of funding). However, due to repeated delays, the entry into force of the main provisions of the 2015 BFL remains uncertain. Recently, a working group to evaluate the implementation of the 2015 BFL and identify the possible need for changes to its current – but still to be fully implemented – text has been appointed and tasked with the preparation of a report to be presented in May 2020. Moreover, additional legislative steps, including the preparation of a decree-law establishing the new budgetary programmes, still need to be undertaken. Likewise, the full application of the new accrual-based public accounting framework is delayed, following implementation lags in particular for local authorities and social security. Putting into effect these reforms could help making public finances more growth-friendly, with potential efficiency gains creating room for high-quality public investment and other growth-friendly spending.

The ongoing plan to improve the sustainability of the health system is a promising initiative, especially if swiftly and forcibly implemented. Portugal has established a track record of in-year accumulation of arrears in hospitals, only partly contained through sizeable ad-hoc arrear clearance measures, with particular incidence in the last months of each year. Despite such measures having led to a visible decrease in hospital arrears by December 2018, they were back on a steadily increasing path between July and November 2019 (reaching a level close to 0.4% of GDP), before another one-time sharp correction in December last year (falling to 0.1% of GDP). The implementation of a comprehensive plan to improve the sustainability of the health system and tackle the root causes of persistently high hospital arrears got under way in 2019, on the basis of recommendations by a temporary task force appointed in 2018. Accordingly, the plan was expected to introduce a new governance model for public hospitals, with substantial increases in hiring autonomy and annual budgets being combined with enhanced joint monitoring by the Ministries of Finance and Health. Meetings with the executive boards of the hospitals within the National Health Service were ongoing throughout 2019 and a formal structure to evaluate the

⁽⁹⁾ See Commission Opinion of 15 January 2020 on the updated Draft Budgetary Plan for Portugal – C(2020) 196.

management of public hospitals in line with the plan's goals was created last June. Moreover, the Ministries of Finance and Health have been working on the setup of management contracts to be concluded with the hospital's executive boards, which are expected to introduce financial incentives and penalties based on performance indicators. At the same time, most of the hospitals' activity and budget plans – which are supposed to spell out their main lines of strategic and operational action and, importantly, their staff and investment planning – are yet to be agreed upon. Compared with the last year's budget, the government budget for 2020 included an increase of around EUR 1 billion (this is, 0.5% of GDP) in the budgetary allocation of the National Health Service for this year, thereby addressing concerns that under-budgeting at the beginning of each year could be one of the factors contributing to the accumulation of arrears in hospitals. That step will constitute an early test to the new governance model, especially as regards the need to ensure effective monitoring and contain moral hazard. In parallel, cost-efficiency continues being promoted in the health system, notably through greater reliance on centralised purchasing of medicines and medical devices, coupled with efforts towards the use of generics and biosimilars.

State-owned enterprises (SOEs) as a whole continue to struggle to achieve a balanced financial position, partly owing to net losses in in the health sector. While compared with 2018 the net incomes of financial SOEs improved significantly throughout 2019, the net incomes of non-financial SOEs worsened in the last two quarters of the year, especially reflecting net losses in SOEs operating in the health sector due to a considerable increase in operational expenditure. As a result, and contrary to the government's initial plans, it is not likely that SOEs as a whole have achieved a balanced financial position in 2019. At the same time, the debt of public non-financial SOEs continued to decrease, though at a decelerating pace, from 18.4% of GDP at the end of 2018, to 16.1% of GDP by the end of 2019. Some measures to improve the sustainability of SOEs are only being implemented gradually; they notably include the analysis of quarterly financial data designed to identify and correct deviations from the approved budgets in good time. There are also plans to eventually introduce new incentives for employees and managers to improve reporting

standards. Moreover, the capital structure of a series of SOEs has been strengthened through sizeable capital injections, while the liquidation of unprofitable or redundant SOEs has been continued. Transparency regarding the financial position of SOEs has also been improved somewhat through the publication of aggregate quarterly financial data within a shorter timeframe.

Recent changes to the legal and institutional framework for public-private partnerships (PPPs) will require close monitoring with a view to containing fiscal risks. During Portugal's economic adjustment programme, the institutional and legal framework for PPPs was significantly strengthened (through Decree-Law No 111/2012 of 23 May). The aim was to end malpractice and uncertainties in the arrangements surrounding PPPs, which had led to a substantial financial burden on public finances. In particular, the revamped framework imposed stricter conditions on new PPPs. These included a cost-benefit test, affordability and compliance with stringent tendering requirements. The overall framework for PPPs was recently revised (through Decree-Law No 170/2019 of 4 December), which included important changes. First, the Council of Ministers – instead of the line Minister and the Minister of Finance – will decide on the launching of any new PPP. Second, while in the past the conditions for launching a new PPP were clearly laid down in law, they are now to be defined on a case-by-case basis for each new PPP, which allows more scope for discretion. Third, the scope of the legal framework for PPPs was visibly narrowed, for instance by excluding from the applicable legal arrangements partnership contracts designed to develop projects under the terms of the recent Housing Basic Law. It is currently unclear to what extent the narrower scope and the greater degree of discretion introduced by the recent changes will weaken the legal and institutional framework for PPPs. It will be important to closely monitor the implementation of these changes to safeguard appropriate control mechanisms and ensure that any new PPPs or similar partnerships have an unquestionable positive cost-benefit ratio. ⁽¹⁰⁾

⁽¹⁰⁾ On 6 March 2020, the Assembly of the Republic suspended the legal force of Decree-Law No 170/2019 of 4 December, which had revised the legal and institutional framework for PPPs.

4. FINANCIAL SECTOR

4.1. FINANCIAL STABILITY

Banks expanded their balance sheets as profitability improved. Total assets of Portuguese banks increased by 3% y-o-y in Q3-2019 on the back of an expanding portfolio of sovereign debt securities and growth in loans granted to the private sector. Non-performing loans (NPL) continued to decrease at a fast pace, with the aggregate NPL ratio dropping below 8% in Q3-2019. The ratio was expected to decline further, reflecting the progress made in the last quarter of 2019. Profitability metrics, such as return on assets (ROA of 0.6% in Q3-2019), have been gradually increasing and stand close to the 2010 levels, while capitalisation levels have practically doubled over the same period. Capital ratios marginally improved in 2019. The CET1 solvency ratio increased by 70 basis points to 13.9% between December 2018 and September 2019, while the Total Capital ratio improved by 120 basis points to 16.4%. There was some heterogeneity across individual banks and the fully loaded CET1 ratios for the largest six banks ranged from 12% to 15% in Q3-2019. Despite a recent pick-up, banks' funding through the issuance of debt securities remained limited. Portuguese lenders started to gradually issue subordinated instruments in line with the Minimum Requirement for own funds and Eligible Liabilities (MREL). Banks will have to comply with their respective MREL targets as of 2024, implying that MREL-related debt issuance will spread over the next three years. Banks expected the funding costs for MREL-eligible instruments to decline, notably as a result of the ongoing cleaning of their balance sheets.

is catching up with the euro area average, but the sustainability of the improvement remains uncertain. Profitability has been gradually improving since end-2017. Most banks reported overall good financial performance in the first three quarters of 2019, with both return on equity (ROE) and assets (ROA) slowly closing the gap to European averages (Table 4.1). Banks have put much effort into cutting operational costs, with a 35% decrease in the number of bank branches and a 20% reduction in the head count over the past decade. The average cost-to-income ratio reported at the end of Q3-2019 was at 57.0%, considerably below the EU and euro area averages of 64.2% and 65.7% respectively. The improvement in profitability has also benefited from a decline in the flow of impairments over the past years. Net interest margins improved on both new business (to 250 bps) and the stock (to 220 bps), mainly because of new deposits bearing virtually no interest rate. Income from fees and commissions remained at similar levels as in 2018, while gains from financial operations decreased somewhat in January-September 2019. In 2019, four out of the six largest banks in the system resumed dividend payments, most of them for the first time since 2010.

Banks have gradually increased their exposure to sovereign debt. Against the backdrop of excess liquidity, Portuguese banks have been gradually increasing their sovereign bond holdings, thereby raising their vulnerability to a potential repricing in bond markets.

Profitability of the Portuguese banking system

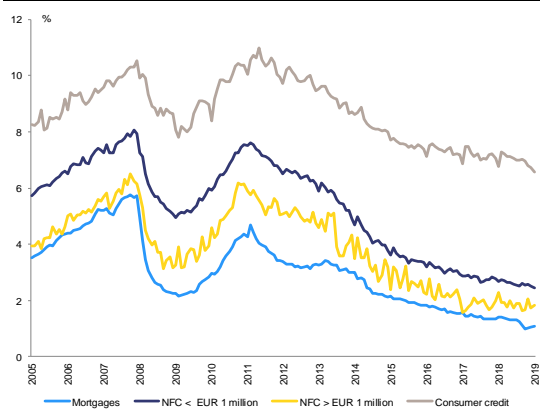
Table 4.1: Financial soundness indicators, domestic banking groups and stand-alone banks (%)

in %	Portugal							Euro area	EU
	2016q4	2017q4	2018q3	2018q4	2019q1	2019q2	2019q3		
Non-performing loans	17.2	13.3	11.3	9.4	8.9	8.3	7.7	3.3	2.8
o/w NFC sector	29.4	25.2	22.1	18.5	17.6	16.6	15.7	5.8	5.5
o/w HH sector	8.7	7.1	6.1	5.1	4.8	4.4	4.0	3.4	3.1
Return on equity⁽¹⁾	-5.5	-0.8	6.2	2.7	6.1	5.3	5.5	6.0	6.7
Return on assets⁽¹⁾	-0.3	0.0	0.6	0.3	0.6	0.5	0.6	0.4	0.4
Total capital ratio	12.3	15.2	15.3	15.2	16.0	16.1	16.4	18.1	18.8
CET 1 ratio	11.4	13.9	13.5	13.2	13.8	13.9	13.9	14.8	15.0
Loan to deposit ratio	80.8	78.9	76.5	76.2	76.2	76.7	77.3	97.8	100.2

(1) Annualised data

Source: ECB - CBD2 - Consolidated Banking data; own calculations

Graph 4.1: Interest rates on new loans granted by banks



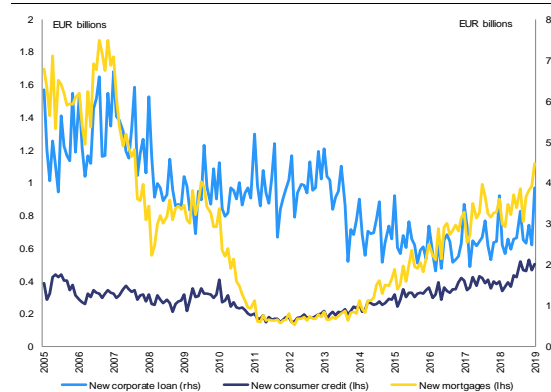
Source: Banco de Portugal

Bank funding costs have declined. At the end of 2019, banks' liabilities were split between customer deposits (59%), interbank funding (14.4%), capital and reserves (12.8%) and long-term debt (3.9%). Deposits were almost evenly split between unremunerated sight deposits and term deposits at a rate close to zero. The Portuguese banking system has abundant liquidity, as reflected in a loan-to-deposit ratio of 77.3% in September 2019, which remained broadly stable over the past two years. According to non-consolidated data, the stock of households' deposits continued to increase (4% y-o-y in November 2019, slightly exceeding the 3.6% growth in disposable income), albeit at a slower pace than in the euro area. Nonetheless, corporate deposits, which account for 22% of total deposits, grew by as much as 9.1% y-o-y in November 2019. As Portuguese law prohibits negative deposit rates, this could induce foreign firms to arbitrage on this prohibition. Borrowing from the ECB has fallen to 5.3% of total assets at the end of 2019, 41 bps below the end-2018 mark. Given the low transformation ratio, banks do not roll over targeted longer-term refinancing operations (TLTRO) in full, also in view of the MREL issuance targets. Given the need to comply with those target only as of 2024 and the current high liquidity environment, many lenders considered it premature to issue MREL instruments before proceeding with their balance sheet clean-up and improving their ratings, thus benefiting from lower funding costs. Capital ratios increased gradually as banks retained part of their past year earnings. The September 2019 CET1 ratio was 90bp and 110bp basis points below euro area and EU averages,

respectively (Table 4.1). CET1 and the total capital ratios were still among the lowest in the EU.

Corporate and mortgage lending flows have picked up. Although the ratio of corporate debt to GDP continued decreasing, the stock of loan to NFCs grew by 0.4% in 2019. The stock of mortgage loans shrank between 2011-2018, but recorded a 0.9% increase in 2019. In terms of new loans, the increase was even higher. Less than half of real estate purchases are financed via domestic mortgages and the remainder by savings and foreign funds.

Graph 4.2: New loans granted



Source: Banco de Portugal

Consumer lending remained the most dynamic lending category. Consumer loans started growing already in 2015, supported by demand factors and recovering consumer confidence. Their stock rose by 7.9% in 2019, while interest rates on consumer loans reached a new historical low of 6.58% at the end of 2019, 19 bps lower than a year earlier. This segment, affected by the borrower-based measure implemented by the Banco de Portugal (see below), remained a relatively lucrative loan category. While it accounted for only 13.4% of outstanding loans, it generated as much as 40% of the loan interest income. To compare, mortgages accounted for 50% of the loan total but generated only 23.2% of the loan interest income. Corporate loans generated 37% of interest income and constituted 37% of the total private sector loans.

Bank lending rates remained under downward pressure. The low interest rate environment, abundant liquidity and signs of strong competition in banking have entailed downward pressure on bank loan pricing. At end September, the weighted

average mortgage interest rate was just 1% but increased to 1.1% in December 2019, still 31 bps below the level of end-2018. Interest rates to the corporate sector also reached new lows with an average of 2.13% at end 2019, 33 bps lower than in December 2018. Going forward, it will be important that banks adequately differentiate their loan pricing according to the risk of the borrower.

Novo Banco continued restructuring its legacy assets. Novo Banco is pursuing its turnaround strategy focused on growing and improving its recurring business and swiftly dealing with the legacy assets. It remained a prime outlet for corporate customers with corporate lending making up 60% of its loan stock, compared to 37% for the banking system. The high NPL ratio (19.5% in Q3 2019) remained a major challenge for Novo Banco and the major reason for generating heavy losses of EUR 4.3 billion between Q3-2017 and Q3-2019. The bank's Contingent Capital Agreement (CCA) with the Resolution Fund, in place until 2025, helps it to reduce its non-performing assets. Losses generated by a ring-fenced pool of legacy assets are covered by the CCA, allowing capital injections (up to a ceiling of EUR 3.9 billion) depending on the bank's capital ratio. The Portuguese Resolution Fund has so far injected in total over EUR 1.9 billion since 2017.

4.2. POLICY ISSUES

Borrower-based macro-prudential measures contribute to sounder credit standards and borrower resilience. The Banco de Portugal introduced borrower-based measures in July 2018, with the aim of strengthening the resilience of both borrowers and the financial system by ensuring prudent credit standards on loans to households. While these measures take the form of non-binding recommendations, the initial evidence suggests that banks are complying with them. Data collected by the Banco de Portugal further show that the share of loans considered to be particularly risky has dropped to a negligible level, suggesting that the imposed limits have been effective in delivering their objective. House prices, which are not directly targeted by the measures, continued to grow at a strong pace over the past year. The Banco de Portugal has recently decided to tighten its measures by shortening the maturity limits for

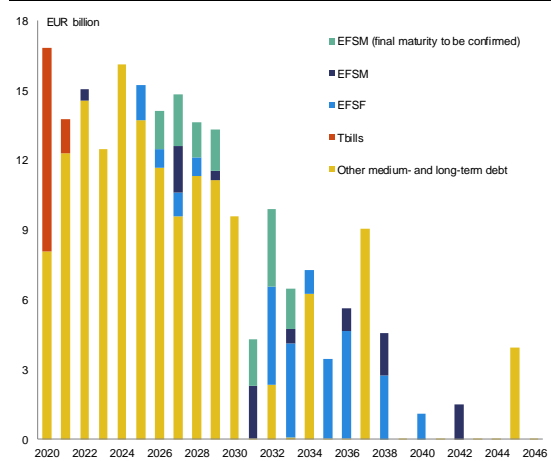
new personal loans from 10 to 7 years and limiting financial institutions' flexibility in exceeding the recommended limit on the debt service-to-income ratio. This tightening was triggered by the progressive lengthening of the average maturity of consumer loans and the continuous increase in the share of personal credit in the 7 to 10-year bucket (from about 20% in 2011 to about 60% at the end of 2019). As regards other macro-prudential measures, the Banco de Portugal maintained the countercyclical capital buffer rate at 0% in the first quarter of 2020, given that the broad range of indicators considered provided no evidence of emerging cyclical systemic risk. As of 2019, six banks were identified as other systemically important institutions and are still phasing-in the associated buffers.

The efficiency of the judicial system continued to face challenges. Over the past years, Portugal implemented a number of reforms to the legal and institutional framework for insolvency and debt enforcement. Most recently, the authorities successfully set up an early warning mechanism that monitors some of the key soundness indicators of Portuguese firms. Portuguese lenders also have (since July 2019) the possibility to make use of a special regime allowing them to transfer loan portfolios in bulk from one financial institution to another. Nevertheless, and in spite of an increased focus on the completion of older cases, the critical challenges related to lengthy proceedings remained (up to 53 months for completed civil enforcement actions in Q3-2019) and a large number of cases were still pending (almost 550,000 in Q3-2019, down 13% y-o-y). These statistics increased the perception of the courts' inefficiencies in an environment of general lack of investment in human resources and modernisation of the judicial system. Therefore, a major programme aimed eventually at the full digitalisation of Portuguese courts has been launched by the government and follows the "digital by default" principle, targeting automation, simplification and outsourcing of the most time-consuming clerical tasks. The legal and judicial frameworks are still heavily affecting the recovery process and the prospects for efficient repossession of collateral. The long average duration of recovery proceedings and the level of uncertainty that accompanies these proceedings because of various delaying tactics applied by delinquent debtors, weigh on the market pricing of non-performing assets.

5. SOVEREIGN FINANCING AND CAPACITY TO REPAY

Portugal's debt management strategy is aimed at reducing the country's interest burden, smoothening the debt redemption profile and diversifying the investor base. Portugal has deployed continuous efforts to reduce overall annual interest expenditure and cap upcoming annual peaks in the debt redemption profile (see Graph 5.1). The financial assistance loans have been fully repaid to the IMF by December 2018. Portugal has also repaid EUR 2 billion in October 2019 in financial assistance loans to the EFSF that were only due in 2025, without that early repayment having required relevant changes to the government's funding programme. In addition, the authorities have conducted throughout 2019 and 2020 exchanges of government bonds maturing in 2020, 2021 or 2022 against new bonds maturing only towards the end of the current decade, while the debt's average residual maturity has remained broadly stable at around 8 years. Moreover, Portugal has continued to further diversify its investor base for sovereign debt, thereby regaining some traditional investors, such as banks.

Graph 5.1: Redemption profile of public debt



(1) Last update: 17-02-2020

Source: IGCP

Following steady decreases for a number of years, Portugal's financing needs were expected to stabilise as from 2020 at the cut-off date of this report. In 2019, Portugal's financing needs were projected to have decreased by EUR 0.9 billion, to EUR 19.4 billion. This decline reflects the lower debt redemptions last year (already including the aforementioned early repayment of financial assistance loans to the EFSF), which was

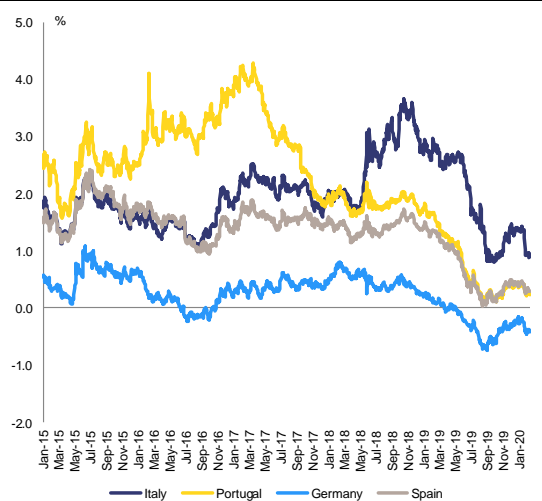
however partly offset by the higher net acquisition of financial assets (due to capital injections and debt assumptions pertaining to SOEs). Looking ahead, Portugal's financing needs were planned to decrease further to EUR 17.6 billion in 2020, before stabilising at around EUR 18 billion in 2021 and 2022. The planned lower State headline deficit on a cash basis and net acquisition of financial assets were expected to exert downward pressure on financing needs between 2020 and 2022, even though this positive trend was expected to be counterbalanced by higher redemptions of government bonds in 2021 and 2022. The cash buffer was planned to be reduced gradually as from 2021 towards a possibly lower medium-term target.

Portugal's high public debt-to-GDP ratio makes it vulnerable to economic shocks. According to the Commission's forecast for the medium term covering the period 2019-2030, under the customary no-policy-change assumption, the public debt-to-GDP ratio was projected to remain on a steady downward path. On that basis, the public debt-to-GDP ratio was expected to cross the threshold of 100% in 2026 and reach a level slightly below 90% by 2030, while remaining significantly above the Treaty reference value of 60%. In the short term, the Commission's assessment of fiscal sustainability challenges for Portugal pointed to low risks (see Annex 1). Conversely, in the medium term, Portugal was considered to face high risks as plausible alternative scenarios incorporating potential shortfalls in nominal GDP growth or interest rate hikes point to public debt-to-GDP ratios still above 90% by 2030. Fiscal sustainability challenges were expected to moderate towards the longer term.

Financing conditions remained particularly favourable for Portugal. Since October 2018, Portugal's sovereign debt rating has an 'investment' grade by all four relevant rating agencies. More recently, on 22 November 2019, Fitch confirmed Portugal's rating at BBB, with a 'positive' outlook. Just before, on 4 October 2019, DBRS upgraded Portugal's sovereign debt to BBB-high, with a 'stable' outlook. During the summer of 2019, also Moody's and Standard & Poor's had improved to 'positive' the outlook for Portugal's sovereign debt. Based on the Commission's forecast, the implicit interest rate on

Portugal’s public debt was projected to have been steadily decreasing since its latest peak of 4.2% in 2011, to around 2.6% in 2019. Moreover, the yields on Portuguese 10-year government bonds were on a declining path between mid-March 2017 and mid-August 2019, when they reached historically low levels of around 0.1% (see Graph 5.2). Subsequently, they increased moderately towards the end of 2019, reaching 0.5% in mid-January 2020, and declined back to 0.3% by end-February 2020. The gradually declining spreads confirm the convergence of Portuguese yields with those of its European peers.

Graph 5.2: 10-year government bond yields



Source: European Commission

Sovereign financing and the capacity to repay are sound. Due to the high public debt-to-GDP ratio, yields remain nevertheless vulnerable. In the short term, Portugal’s capacity to repay remains sound, with stable and low yields, a relatively smooth redemption profile and declining gross financing needs, as well as anchored in a solid cash buffer. In the long term, progress with growth-friendly fiscal consolidation and fiscal-structural reforms would nonetheless be important to further strengthen Portugal’s fiscal sustainability and the country’s capacity to repay.

ANNEX 1

European Commission debt sustainability analysis

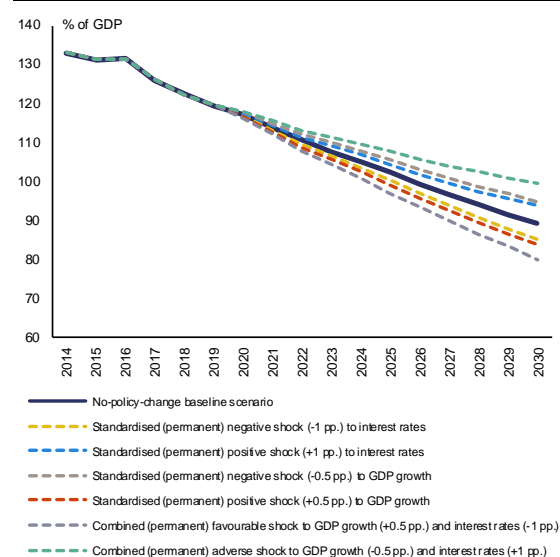
The present Debt Sustainability Analysis (DSA) uses the Commission 2019 autumn forecast as a starting point to ensure cross-country consistency and to allow factoring in second-round macroeconomic effects; a few technical assumptions are also made for the medium term.⁽¹¹⁾ Where relevant, it also takes into consideration an updated no-policy-change baseline based on the Commission ad-hoc forecast.⁽¹²⁾ The S-indicators used in the assessment of fiscal sustainability challenges in the short, medium and long term have been estimated based on the Commission ad-hoc forecast.

In the short term, Portugal is projected to face low risks to fiscal sustainability, despite its high public debt-to-GDP ratio. The S0 indicator (which evaluates fiscal sustainability risks in the short term, stemming from the fiscal, macro-financial or competitiveness sides of the economy) is estimated at 0.33 and is therefore below its critical threshold (0.46). In particular, both the fiscal and the financial competitiveness sub-indices have values below their critical thresholds. This is confirmed by the lower spreads of credit default swaps and gradually improving credit ratings during 2019, which allows Portuguese sovereign debt holdings to be included in wide institutional investor portfolios based on the ‘investment’ grade credit assessment by all four relevant rating agencies.

In the medium-term, Portugal is however projected to face high risks to fiscal sustainability. The assessment of medium-term fiscal sustainability risks reflects an overall conclusion based on the S1 indicator and Portugal’s DSA. First, the S1 indicator (which evaluates fiscal sustainability risks in the medium term) is estimated at 2.1 and is therefore below its upper critical threshold (2.5), thereby indicating medium, but close to high, fiscal sustainability risks in the medium term. In practice, this suggests that a cumulated additional

improvement in the structural primary balance by 2.1% of GDP over 5 years, compared with the Commission’s no-policy-change baseline scenario (based on the ad-hoc forecast), would be required to bring the public debt-to-GDP ratio down to the Treaty reference value of 60% by 2034. 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, although the Commission’s no-policy-change baseline scenario entails medium fiscal sustainability risks in the medium term, the Commission’s DSA points to overall high risks based on plausible alternative scenarios that project public debt-to-GDP ratios above 90% by 2030 (based on the 2019 autumn forecast).

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



Source: European Commission (based on 2019 autumn forecast)

The Commission’s DSA, which covers the period 2019-2030, confirms that the public debt-to-GDP ratio would be sensitive to any worsening of Portugal’s economic and financing conditions. According to the Commission’s no-policy-change baseline scenario based on the 2019 autumn forecast, the public debt-to-GDP ratio is expected to continue falling at a moderating pace by close to 3 pps per year to a level slightly below 90% by 2030, thereby still remaining significantly above the Treaty reference value of 60%. In particular, the public debt-to-GDP ratio would cross the threshold of 100% only in 2026. This is confirmed

⁽¹¹⁾ These assumptions comprise: (i) a structural primary balance, before ageing costs, of 2.4% of GDP as of 2021; (ii) inflation converging to 2.0% by 2024; (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 2029 (as for all Member States); (iv) real GDP growth rates on average slightly below 1%; and, (v) ageing costs in line with the Ageing Report 2018 by the European Commission. More details on the assumptions can be found in the European Commission Debt Sustainability Monitor 2019.

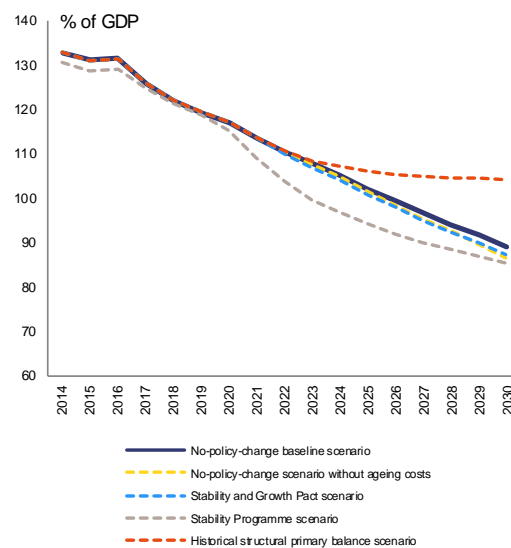
⁽¹²⁾ See footnote 5.

if the Commission’s no-policy-change baseline scenario is updated based on the ad-hoc forecast. The projected gradual decrease in Portugal’s public debt-to-GDP ratio crucially hinges on continuous primary surpluses and favourable nominal growth-interest rate differentials in the projection’s outer years. In plausible scenarios alternative to the Commission’s no-policy-change baseline scenario based on the 2019 autumn forecast – incorporating potential shortfalls in nominal GDP growth or interest rate hikes – the public debt-to-GDP ratio would still be forecast to be on a steady downward path. That notwithstanding, the pace of debt reduction would be significantly impaired and it would thus take longer for the public debt-to-GDP ratio to pass under the threshold of 100% (see Graph A1.1). The projections for the public debt-to-GDP ratio in the medium term underlying the latest DSA exhibit a more downward-sloping path as compared with previous exercises. This partly reflects the new baseline interest rate projection based on forward interest rates (which are currently low), as opposed to the previous baseline based on historical averages (which were higher for Portugal).⁽¹³⁾

A growth-friendly fiscal consolidation strategy remains instrumental to safeguard Portugal’s fiscal sustainability in the medium term. If Portugal’s structural adjustment were consistently in full compliance with the SGP, notably through fully adhering to its current MTO – a balanced budgetary position in structural terms –, the public debt-to-GDP ratio would be below both the threshold of 90% and the Commission’s no-policy-change baseline scenario by 2030 (see Graph A1.2). Conversely, 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 0.5% of GDP), the public debt-to-GDP ratio would stabilise at around 105%, as much as 15 pps above the Commission’s no-policy-change baseline scenario. In addition, debt-increasing costs stemming from demographic ageing are projected to deter the speed of debt reduction by close to 3 pps by 2030. Portugal’s currently favourable economic and financing conditions offer a window of opportunity to deploy

a growth-friendly fiscal consolidation strategy and implement fiscal-structural reforms that could help accelerating the reduction of its public debt-to-GDP ratio and strengthening its resilience to any potentially worsening economic, financing and demographic trends in the medium term.

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



Source: European Commission (based on 2019 autumn forecast)

In the long term, risks to Portugal’s fiscal sustainability are expected to lessen to medium. The S2 indicator (which evaluates fiscal sustainability risks in the long term) is estimated at -0.36 and is therefore below its lower critical threshold (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.

⁽¹³⁾ See “Box 3.1: Revision of interest rate assumptions – rationale, description and impact” in the European Commission Debt Sustainability Monitor 2019.

ANNEX 2

European Commission macroeconomic and fiscal projections

Source: Assessment of the 2020 Draft Budgetary Plan, Commission ad-hoc forecast, December 2019

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

<i>Annual % change</i>	2015	2016	2018	2019	2020	2021
1. Private consumption expenditure			3.1	2.3	1.9	1.9
2. Government consumption expenditure			0.9	0.8	0.8	0.8
3. Gross fixed capital formation			5.8	6.5	4.8	5.0
4. Final domestic demand			3.2	2.8	2.3	2.3
5. Change in inventories			--	--	--	--
6. Domestic demand			3.3	2.8	2.3	2.3
7. Exports of goods and services			3.8	2.7	2.7	2.8
7a. - of which goods			3.2	2.6	2.7	2.8
7b. - of which services			4.8	3.0	2.8	2.8
8. Final demand			3.4	2.8	2.4	2.4
9. Imports of goods and services			5.8	4.7	3.9	4.0
9a. - of which goods			5.5	4.5	4.1	4.2
9b. - of which services			7.1	5.7	3.2	3.1
10. Gross domestic product at market prices			2.4	2.0	1.7	1.7
<i>Contribution to change in GDP</i>						
11. Final domestic demand			3.1	2.8	2.3	2.3
12. Change in inventories + net acq. of valuables			0.1	0.1	0.0	0.0
13. External balance of goods and services			-0.8	-0.9	-0.6	-0.6

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

<i>Annual % change</i>	2015	2016	2018	2019	2020	2021
1. Private consumption expenditure			4.4	2.8	3.2	3.3
2. Government consumption expenditure			2.7	5.0	4.4	4.2
3. Gross fixed capital formation			9.0	8.6	6.5	6.7
4. Final domestic demand			4.9	4.2	4.0	4.1
5. Change in inventories			--	--	--	--
6. Domestic demand			5.0	4.2	3.8	3.9
7. Exports of goods and services			6.0	4.4	3.7	3.8
8. Final demand			5.3	4.3	3.7	3.9
9. Imports of goods and services			8.3	6.3	4.9	5.1
10. Gross national income at market prices			4.2	3.6	3.4	3.6
11. Gross value added at basic prices			3.8	3.3	3.2	3.4
12. Gross domestic product at market prices			4.1	3.4	3.2	3.4
Nominal GDP, EUR bn			203.9	210.8	217.6	225.0

Table 3: Implicit price deflators

<i>% change in implicit price deflator</i>	2015	2016	2018	2019	2020	2021
1. Private consumption expenditure			1.3	0.5	1.2	1.4
2. Government consumption expenditure			1.8	4.3	3.6	3.4
3. Gross fixed capital formation			3.0	2.0	1.6	1.6
4. Domestic demand (incl. inventories)			1.7	1.4	1.5	1.6
5. Exports of goods and services			2.1	1.6	0.9	1.0
6. Final demand			1.8	1.4	1.3	1.4
7. Imports of goods and services			2.4	1.5	0.9	1.0
8. Gross domestic product at market prices			1.6	1.4	1.5	1.6
HICP			1.2	0.3	1.1*	1.4*

*In February 2020 HICP was revised to 1.0% in 2020 and 1.3% in 2021

Table 4: Labour market and cost

<i>Annual % change</i>	2015	2016	2018	2019	2020	2021
1. Labour productivity (real GDP per employee)			0.1	1.0	1.2	1.2
2. Compensation of employees per head			2.5	3.2	2.9	2.8
3. Unit labour costs			2.4	2.2	1.7	1.6
4. Total population			-0.2	0.0	0.0	0.0
5. Population of working age (15-74 years)			-0.1	0.0	0.0	0.0
6. Total employment (fulltime equivalent)			2.3	1.0	0.5	0.5
7. Calculated unemployment rate - Eurostat definition (%)			7.0	6.4	6.0	5.7

Table 5: External balance

<i>levels, EUR bn</i>	2015	2016	2018	2019	2020	2021
1. Exports of goods (fob)			56.4	58.7	60.6	62.7
2. Imports of goods (fob)			72.5	76.9	80.7	84.9
3. Trade balance (goods, fob/fob) (1-2)			-16.2	-18.3	-20.1	-22.2
3a. p.m. (3) as % of GDP			-7.9	-8.7	-9.3	-9.9
4. Exports of services			32.4	34.0	35.4	37.0
5. Imports of services			16.0	17.2	18.0	18.9
6. Services balance (4-5)			16.3	16.7	17.4	18.1
6a. p.m. 6 as % of GDP			8.0	7.9	8.0	8.0
7. External balance of goods & services (3+6)			0.2	-1.5	-2.7	-4.1
7a. p.m. 7 as % of GDP			0.1	-0.7	-1.3	-1.8
8. Balance of primary incomes and current transfers			0.1	0.5	1.2	1.7
8a. - of which, balance of primary income			-4.5	-4.3	-4.1	-3.7
8b. - of which, net current Transfers			4.6	4.8	5.2	5.4
8c. p.m. 8 as % of GDP			0.1	0.3	0.5	0.7
9. Current external balance (7+8)			0.3	-1.0	-1.6	-2.4
9a. p.m. 9 as % of GDP			0.1	-0.5	-0.7	-1.1
10. Net capital transactions			2.1	2.4	2.7	3.0
11. Net lending (+)/ net borrowing (-) (9+10)			2.4	1.5	1.1	0.6
11a. p.m. 11 as % of GDP			1.2	0.7	0.5	0.3

Table 6: Fiscal accounts

	2018	2019	2020	2021
% of GDP				
Taxes on production and imports	15.2	15.2	15.3	15.3
Current taxes on income, wealth, etc.	10.1	10.0	10.0	10.1
Social contributions	11.7	11.9	12.0	12.0
Sales and other current revenue	5.6	5.8	6.0	5.8
Total current revenue	42.6	42.9	43.3	43.2
Capital transfers received	0.4	0.3	0.4	0.9
Total revenue	43.0	43.3	43.7	44.0
Compensation of employees	10.7	10.8	11.0	11.0
Intermediate consumption	5.4	5.4	5.4	5.4
Social transfers in kind via market producers	1.8	1.9	1.8	1.8
Social transfers other than in kind	16.4	16.6	16.6	16.5
Interest paid	3.4	3.1	2.9	2.7
Subsidies	0.4	0.4	0.4	0.3
Other current expenditure	2.3	2.4	2.5	2.5
Total current expenditure	40.4	40.5	40.6	40.3
Gross fixed capital formation	1.9	1.9	2.1	2.3
Other capital expenditure	1.2	1.0	0.9	0.7
Other (residual)	3.5	3.4	3.4	3.2
Interest expenditure	3.4	3.1	2.9	2.7
Total expenditure	43.5	43.4	43.6	43.3
General Government balance (ESA2010)	-0.4	-0.1	0.1	0.7
Primary balance	2.9	3.0	3.0	3.4
% change				
Taxes on production and imports	6.2	3.8	3.6	3.3
Current taxes on income, wealth, etc.	6.5	1.8	3.3	4.0
Social contributions	5.0	5.0	4.1	3.3
Sales and other current revenue	2.4	7.8	6.6	0.4
Total current revenue	5.4	4.2	4.1	3.1
Capital transfers received	15.4	-12.6	23.2	115.2
Total revenue	5.5	4.0	4.2	4.1
Compensation of employees	2.1	4.5	4.8	3.3
Intermediate consumption	4.7	2.4	3.8	3.4
Social transfers in kind via market producers	2.3	7.6	1.1	3.3
Social transfers other than in kind	3.1	4.3	3.6	2.9
Interest paid	-6.8	-5.2	-3.6	-2.9
Subsidies	-8.8	11.8	2.2	-9.5
Other current expenditure	11.2	7.4	7.4	3.4
Total current expenditure	2.4	3.7	3.5	2.6
Gross fixed capital formation	8.5	6.0	13.9	13.3
Other capital expenditure	-50.1	-16.1	-4.8	-16.7
Total expenditure	-0.3	3.2	3.8	2.7
Nominal GDP, EUR bn	203.9	210.8	217.6	225.0

Table 7: Government debt developments

	2018	2019	2020	2021
ESA2010 deficit (% of GDP)	-0.4	-0.1	0.1	0.7
ESA2010 gross debt (% of GDP)	122.2	119.2	116.7	113.4
ESA2010 deficit	-0.9	-0.2	0.2	1.6
Gross debt	249.1	251.3	254.0	255.2
Change in gross debt	2.2	2.2	2.7	1.1
Nominal GDP	203.9	210.8	217.6	225.0
Real GDP growth (% change)	2.4	2.0	1.7	1.7
Change in gross debt (% of GDP)	1.1	1.0	1.2	0.5
Stock-flow adjustments (% of GDP)	0.6	0.9	1.3	1.2
Gross debt ratio	122.2	119.2	116.7	113.4
Change in gross debt ratio	-3.8	-3.0	-2.5	-3.3
Primary balance	2.9	3.0	3.0	3.4
"Snow-ball" effect	-1.4	-1.1	-0.9	-1.0
of which				
<i>Interest expenditure</i>	3.4	3.1	2.9	2.7
<i>Real growth effect</i>	-2.9	-2.4	-1.9	-1.9
<i>Inflation effect</i>	-1.9	-1.9	-1.8	-1.8
Stock-flow adjustments	0.6	0.9	1.3	1.2
<i>Implicit interest rate</i>	2.8	2.6	2.5	2.4

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