Portuguese Republic
Rating Report

Credit strengths

- Status as a euro area member
- Good record of fiscal consolidation and structural reform
- Resilient public debt structure

Credit challenges

- Elevated stock of public debt and implicit liabilities
- Moderate growth potential
- Vulnerability to shocks as a small, open economy

Rating rationale

Core euro area member: Portugal benefits from its euro area membership, strengthening the country's resilience to global shocks.

Good record of fiscal consolidation and structural reform: The Portuguese government put the country on a robust path of fiscal consolidation. Structural reforms have improved the business environment, and incoming EU funds support long-term growth prospects.

Debt profile and market access: The Portuguese treasury benefits from strong market access, facilitated by the ECB's accommodative monetary policy, favourable debt profile and high cash buffer.

Rating challenges include: i) an elevated stock of public debt and implicit liabilities; ii) moderate growth potential reflecting adverse demographic trends, impacting the labour force and public spending; and iii) the small, open economy's vulnerability to shocks.

Portugal's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic economic risk		35%	aa		-2/3	BBB+
Public finances risk		25%	a-		0	
External economic risk		10%	ccc		-2/3	
Financial stability risk		10%	aa+		0	
ESG risk	Environmental risk	5%	aaa		0	
	Social risk	5%	bb+		-1/3	
	Governance risk	10%	a+		0	
Overall outcome		**a-**		**+1**	**-2**	

Note: The sum of the qualitative adjustments, capped at one notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's Sovereign Rating Methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Positive Outlook reflects our view that risks to the ratings are titled to the upside over the next 12 to 18 months. We expect the combined effects of a credible long-term fiscal consolidation plan, relative political stability, sound long-term growth prospects and incoming EU funds will put Portugal's debt-to-GDP ratio on a firm downward trajectory. A favourable debt profile with a high cash buffer should underpin improved fiscal consolidation.

Positive rating-change drivers

- Stronger debt sustainability, with a steady reduction in the public debt burden
- Better growth prospects

Negative rating-change drivers

- Weaker fiscal outlook, weighing on debt sustainability
- Fading commitment to structural reforms, leading to markedly lower GDP growth
- Materialisation of contingent liabilities, materially weighing on sovereign's balance sheet

Ratings and Outlook

Local and foreign currency

Long-term issuer rating BBB+/Positive

Senior unsecured debt BBB+/Positive

Short-term issuer rating S-2/Positive

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Bloomberg: RESP SCOP

Domestic economic risk

- **Growth outlook**: Portugal was hit particularly hard by the pandemic, recording an 8.4% decline in GDP in 2020, worse than the euro area (negative 6.4%) but better than peers such as Italy (negative 8.9%) and Spain (negative 10.8%). Economic activity returned to its pre-pandemic level in 2021 with higher-than-expected growth of 4.9% in 2021. We expect real growth of 4.2% in 2022 and 2.0% in 2023, supported by spending from accumulated savings during the pandemic and tourism export. The economy's moderate growth potential, inhibited by low productivity gains, and its vulnerability to shocks in view of an uncertain global environment remain key challenges.

- The tourism sector occupies an outsized position in the Portuguese economy, accounting for 17.1% of GDP and 20.7% of employment before the pandemic. International tourism recovered in the second half of 2021, moving closer to pre-pandemic levels. Portugal's long-term growth prospects are supported by the government's Recovery and Resilience Plan, through which it is set to receive EUR 13.9 bn in EU grants and EUR 2.7 bn in EU loans by 2026. These funds will be directed towards investments supporting resilience (EUR 11bn), the climate transition (EUR 3bn) and the economy's digital transition (EUR 2.5bn). Portugal has a good track record of EU funds absorption.

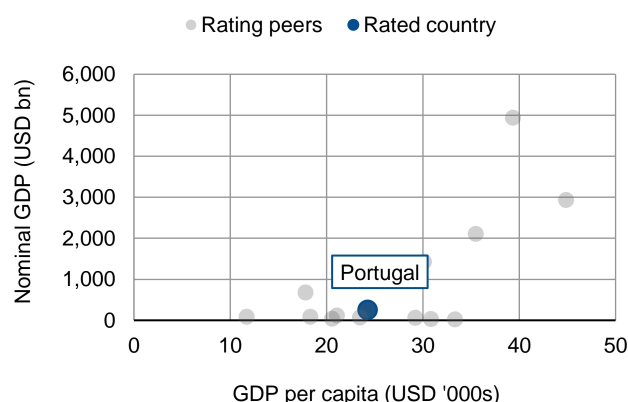
  Inflation and monetary policy: Inflation is set to rise to around 4% in 2022, with the recent rise in food and energy prices representing a shock to purchasing power. However, we expect the shock from higher energy prices to be more contained in Portugal (and Spain) than in the euro area. This is due to low reliance on Russian energy and a temporary mechanism (lasting 12 months) that will cap the price of natural gas, resulting in lower electricity bills for a notable share of Spanish and Portuguese consumers with regulated rates. The Portuguese government expects to make up those costs through additional levies on energy companies' windfall profits.

- **Labour market**: Government job retention schemes helped contain the pandemic's impact on the labour market. By mid-2021, all labour market indicators except for hours worked had returned to their pre-crisis level. We expect the unemployment rate to fall to 5.7% in 2022 and 5.6% in 2023 (from 6.6% in 2021).

Overview of our qualitative assessments for Portugal's *domestic economic risk*

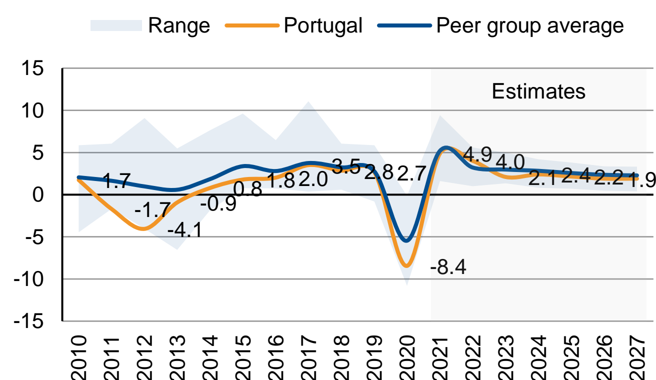
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Growth potential of the economy	Weak	-1/3	Moderate growth potential despite a significant wealth gap versus euro area peers
	Monetary policy framework	Neutral	0	Credible and effective central bank; appropriate response to the pandemic
	Macroeconomic stability and sustainability	Weak	-1/3	Limited diversification; low share of high-value added sectors

Nominal GDP and GDP per capita, USD '000s



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

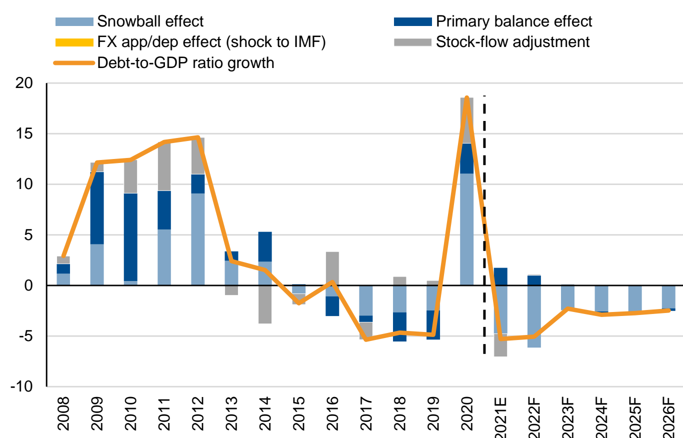
Public finances risk

- **Fiscal outlook**: The overall government deficit stood at negative 2.8% in 2021. We expect this to gradually decline going forward, from 2.0% of GDP in 2022 to 1.0% of GDP in 2023 backed by an improving primary balance. This view is supported by the Portuguese government's good record of primary surpluses in recent years, with an average primary balance of positive 1.85% of GDP over 2015-19 and a reduction in the primary deficit to 0.4% in 2021 (from 2.9% in 2020).
- The government's comfortable absolute majority bolsters the credibility of fiscal consolidation. The approval of a new budget for 2022 following the re-election is unlikely before July given that Russia's invasion of Ukraine requires budgetary modifications to capture increased social and military spending. Going forward, the credible fiscal consolidation plan aims to achieve high primary surpluses averaging 1.9% of GDP in 2023-25 and preserve a high cash buffer that amounted to 7.4% of GDP in 2021. These factors should underpin improved fiscal consolidation.
- **Debt trajectory**: High primary surpluses in 2015-19 supported a material reduction in public debt, from 131.2% of GDP to 116.6% of GDP. After a pandemic-related increase in public debt levels to 135.2% of GDP in 2020, the downward trend resumed in 2021, when the debt-to-GDP ratio declined to 127.3%. The strong economic recovery and gradual return to primary surpluses is supporting the return to a steady downward trend. We expect the debt-to-GDP ratio to decline to 106% of GDP in 2026. State guarantees are estimated at 9.0% of GDP, with the majority related to the provision of credit lines during the pandemic.
- **Market access:** Portugal benefits from strong market access, with the cost of outstanding debt on a steady declining trend in recent years, at 2.2% of GDP in 2020 and 1.9% in 2021, down from 4.1% in 2011. Cost of issuance stood at 0.6% in 2021 and is expected at 1.1% in 2022. Average debt maturity stood at around 7.7 years as of February 2022.

Overview of our qualitative assessments for Portugal's *public finances risk*

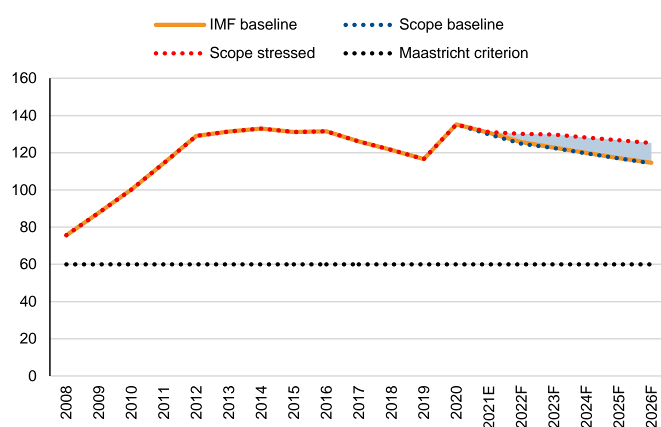
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Neutral	0	Good record of prudent fiscal policy, including elevated primary surpluses prior to Covid-19 shock
	Debt sustainability	Neutral	0	Downward debt trajectory expected, although debt is likely to remain elevated over the longer term
	Debt profile and market access	Neutral	0	Strong market access in line with peers, high cash buffer and resilient public debt structure

Contributions to changes in debt levels, pp of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

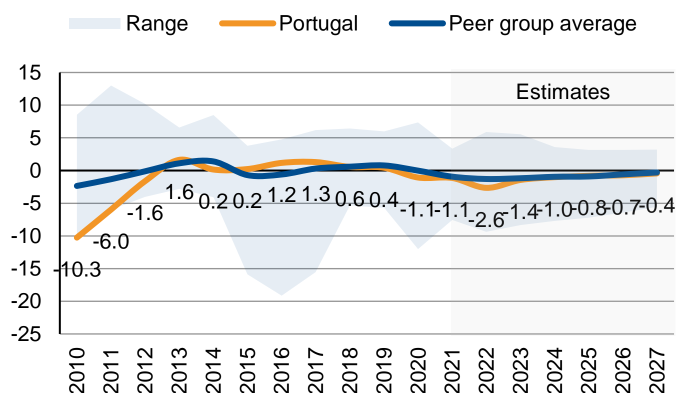
External economic risk

- **Current account**: Portugal's external position showed a positive trend in the years leading up to the pandemic, generating current account surpluses averaging close to 0.8% of GDP between 2013 and 2019. The current account balance moved to a deficit of 1.1% of GDP in 2020 and 2021 due to the fall in receipts from foreign tourism and related passenger transport services.
- The deficit in the trade of goods is likely to widen further due to a strong rebound in consumer demand and higher import prices. We expect Portugal's external balance to gradually improve in the next few years in parallel with the progressive recovery in foreign tourism. Direct trade exposure with Ukraine or Russia is low (less than 1% of total imports and exports), and only around 10% of its natural gas imports come from Russia.
- **External position**: The large negative NIIP improved to negative 91.8% in 2021 from negative 112.7% in 2020. Risks associated with the elevated level of external debt are partially offset by its favourable composition, with an increasing share of equity-based foreign direct investment. The country's gross external debt is elevated, ranging from 201% of GDP as of end-2020 to 191.8% as of September 2021, above the euro area average (122.9%).
- **Resilience to shocks**: All euro area members including Portugal benefit from the euro's status as a global reserve currency, significantly mitigating risks to external shocks. However, the mall and highly open economy's current account balance and GDP growth are highly dependent on the economic outlook of key trading partners and tourism export.

Overview of our qualitative assessments for Portugal's *external economic risk*

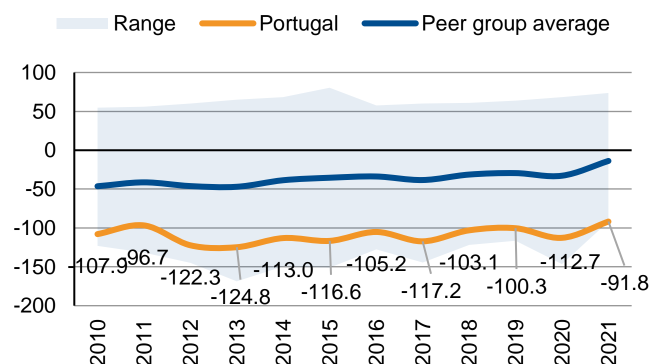
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Weak	-1/3	Dependence on tourism sector may temporarily weaken external trade
	External debt structure	Neutral	0	Elevated debt stock, with meaningful shares held by the government and central bank
	Resilience to short-term shocks	Weak	-1/3	Small and highly open economy; uncertain external environment

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

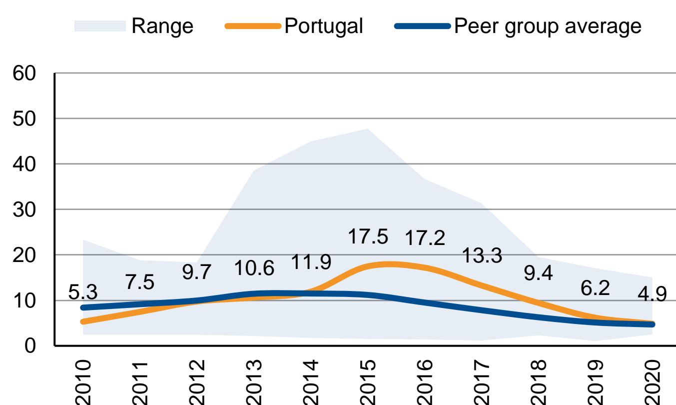
Financial stability risk

- **Banking sector**: The Portuguese banking sector has remained stable throughout the pandemic, maintaining comfortable liquidity (liquidity coverage ratio of 249.5% at Q4 2021) and adequate capital buffers (CET1 ratio at 16.3% in 2021). Non-performing loan (NPL) ratios are elevated compared to peers but declined to 4.9% by end 2020 and to 3.5% by end 2021, down from a high of almost 18% in 2016. A gradual lifting of the loan moratorium carries uncertainty for banks' asset quality and could lead to a rise in NPLs. Novo Banco remains a contingent liability for Portugal.
- **Private debt**: Non-financial corporate (NFC) debt peaked at 118.4% of GDP as of Q2 2020 (last reached in 2015) and decreased to 100.4% as of Q3 2021 (BIS), mostly driven by the catch-up in GDP. After a prolonged decline that began in 2009, household indebtedness as measured by the debt-to-disposable-income ratio increased moderately in 2020 and stood at 94.4% as of Q4 2021. Banco de Portugal expects the savings rate to decrease to 7.3% in 2022 (from 10.3% in 2021) and remain relatively stable in 2023 and 2024.
- **Financial imbalances**: House prices have continued to rise and are back to pre-pandemic growth levels, with an increase of 11.6% YoY as of Q4 2021 compared to 7.9% YoY in Q4 2020. Low interest rates and increased household savings should support demand for housing in the medium term. However, certain segments of the market, such as those that are linked to demand from non-residents or associated with tourism, remain exposed to substantial volatility.

Overview of our qualitative assessments for Portugal's *financial stability risk*

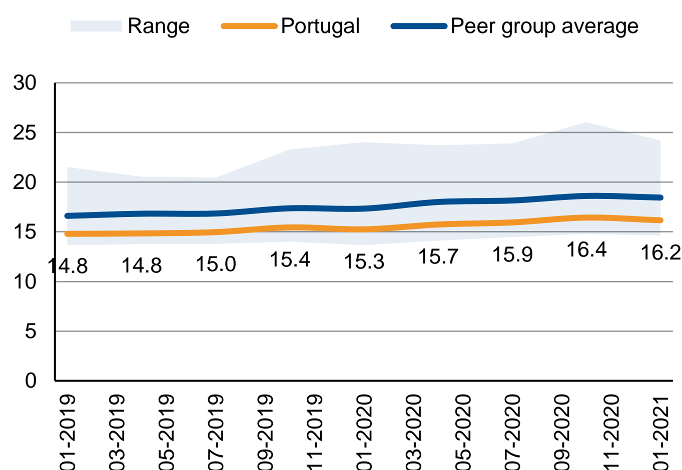
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound but profitability is declining.
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union authorities and Banco de Portugal
	Financial imbalances	Neutral	0	Low savings and high but declining private indebtedness; challenges to private sector debt service

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

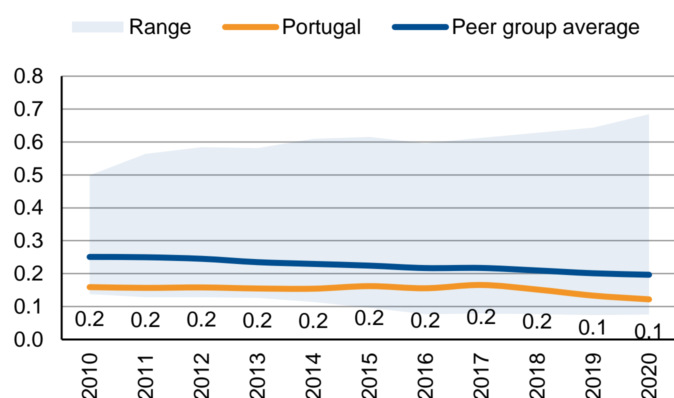
ESG risk

- **Environment**: The country is exposed to significant physical risks resulting from natural disasters, given that it has experienced extensive droughts and forest fires in recent years. The Portuguese government was one of the first in the EU to commit to net zero emissions by 2050. It has rolled out ambitious policies to achieve that goal such as the 2014 Green Taxation Law, which introduced a carbon tax. Challenges are related to Portugal's high energy import dependency. This figure stood at 65.3% in 2020, although that was lower than the 74% seen in 2019. Portugal has developed a renewables sector that was responsible for 63.64% of electricity generation in January 2022. Recent policy actions show the transition to green energy is accelerating, notably through additional subsidies for solar panels.
- **Social**: Portugal has achieved improvements in the European Commission's Social Scoreboard with regards to its labour market performance and a reduction in gender and income inequality. Yet significant social risks remain, reflected in a high rate of people at risk of social exclusion (20% in 2020) and a low degree of social mobility (the country ranked 24th in the World Economic Forum's 2020 Global Social Mobility Index). Portugal is also facing severe adverse age dynamics impacting public spending, with an old-age dependency ratio forecasted to rise above 60 by 2050, one of the highest levels in the EU.
- **Governance**: Our expectation of a broadly unchanged fiscal policy stance over the next few years is underpinned by the country's stable political environment. Portugal benefits from a resilient institutional framework and a good record of prudent fiscal policy and structural reform, including current account rebalancing and structural unemployment reduction.

Overview of our qualitative assessments for Portugal's *ESG risk*

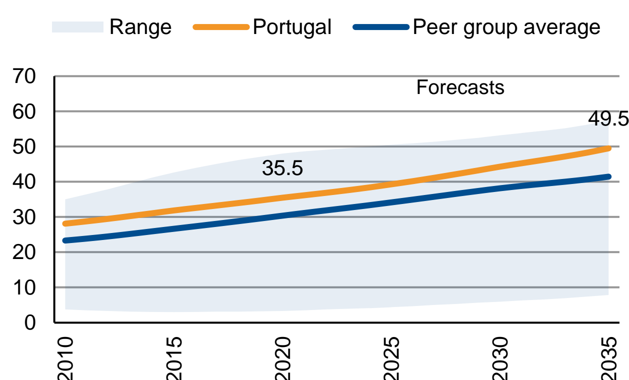
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Environmental risk	Neutral	0	Exposure to natural disasters, ambitious commitment to achieve carbon neutrality by 2050
	Social risk	Weak	-1/3	Adverse demographics; income inequality and risk of social exclusion
	Institutional and political risk	Neutral	0	Resilient institutional framework; comparatively reform-oriented political environment

CO_2 emissions per GDP, mtCO2e



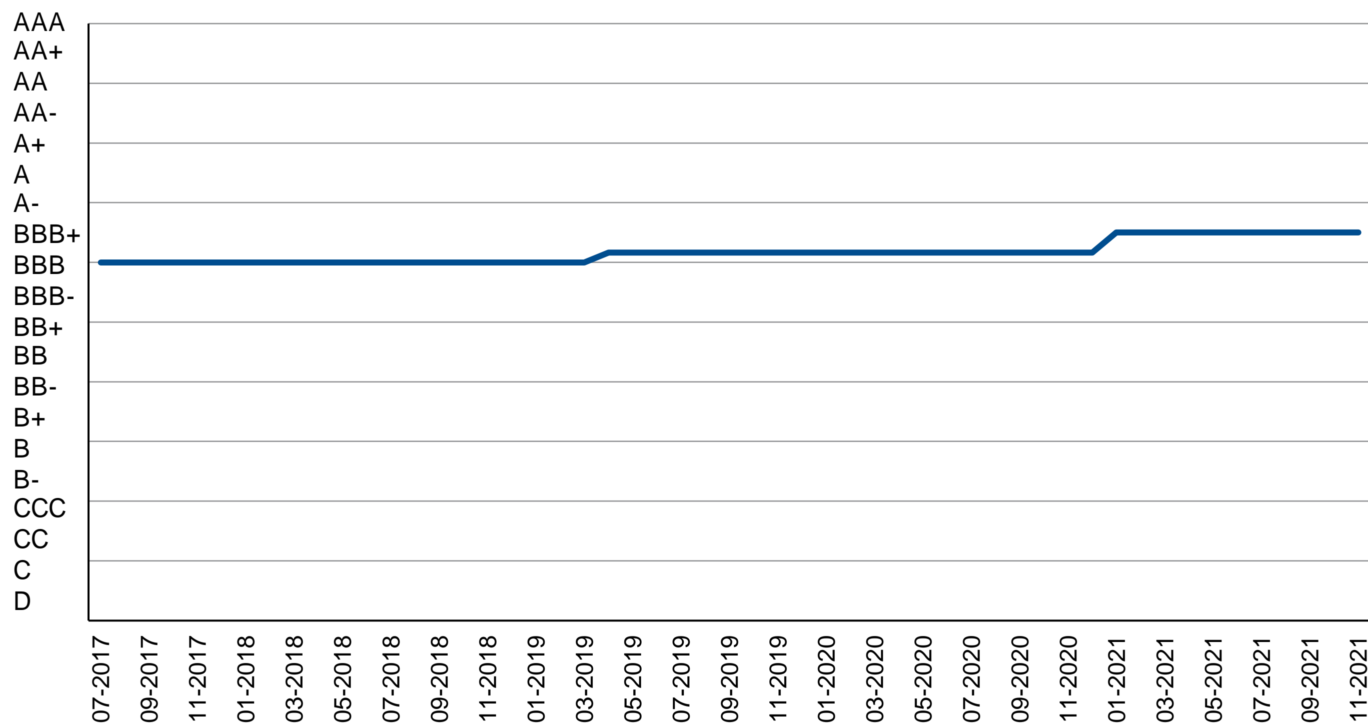
Source: European Commission, Scope Ratings GmbH

Old-age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's core variable scorecard.

Peer group*
Bulgaria
Cyprus
France
Italy
Japan
Latvia
Lithuania
Malta
Poland
Portugal
Slovakia
Slovenia
Spain

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

	2017	2018	2019	2020	2021	2022F	2023F
Domestic economic risk							
GDP per capita, USD '000s	21.5	23.6	23.3	22.2	24.3	24.5	26
Nominal GDP, USD bn	221.3	242.4	240	228.4	250.1	251.9	267.2
Real growth, %[1]	3.5	2.8	2.7	-8.4	4.9	4.2	2
CPI inflation, %	1.6	1.2	0.3	-0.1	0.9	4	1.5
Unemployment rate, %[1]	9.2	7.2	6.7	7.1	6.6	5.7	5.6
Public finances risk							
Public debt, % of GDP[1]	126.1	121.5	116.6	135.2	127.5	121	118.5
Interest payment, % of government revenue	8.5	7.5	6.6	6.4	5.1	4.9	4.8
Primary balance, % of GDP[1]	0.7	2.9	2.9	-3.1	-0.5	-0.3	0.5
External economic risk							
Current account balance, % of GDP	1.3	0.6	0.4	-1.1	-1.1	-2.6	-1.4
Total reserves, months of imports	2.9	2.5	2.5	3.5	3.1	-	-
NIIP, % of GDP	-117.2	-103.1	-100.3	-112.7	-91.8	-	-
Financial stability risk							
NPL ratio, % of total loans	13.2	9.4	6.2	4.9	-	-	-
Tier 1 ratio, % of risk-weighted assets	14.4	13.9	15.4	16.4	16.3	-	-
Credit to private sector, % of GDP	102.6	97	90.3	101.2	-	-	-
ESG risk							
CO_2 per EUR 1,000 of GDP, mtCO2e	165.6	151.7	133.3	121.9	-	-	-
Income quintile share ratio (S80/S20), x	5.6	5.6	5.4	-	-	-	-
Labour force participation rate, %	74.9	75.4	75.8	-	-	-	-
Old-age dependency ratio, %	33.3	34	34.7	35.5	36.2	36.9	37.6
Composite governance indicator[2]	1.1	1.1	1.1	1	-	-	-

This table presents a selection of the indicators (24 out of 29) used in Scope's quantitative model, the core variable scorecard.

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections.
[2] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 10 May 2022	50

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