28 October 2022 | Sovereign and Public Sector

Portuguese Republic
Rating Report

BBB+ POSITIVE OUTLOOK

Credit strengths

- Status as a euro area member
- Good record of fiscal consolidation and structural reform
- Favourable debt profile and high cash buffer

Credit challenges

- Elevated stock of public debt
- 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, favourable debt profile and comfortable 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		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	a+	EUR [+1]	-2/3	BBB+
Public Finance Risk		20%	a-		0	
External Economic Risk		10%	ccc		-2/3	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Factors	5%	aa		0	
	Social Factors	7.5%	b-		-1/3	
	Governance Factors	12.5%	aa-		0	
Indicative outcome		**a**			**-2**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment 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 Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Positive Outlook reflects Scope's view that risks to the ratings are tilted to the upside over the next 12 to 18 months.

Positive rating-change drivers

- Strengthened debt sustainability, underpinned by sustained improvements in Portugal's fiscal fundamentals
- Improved medium-term growth prospects, supported by implementation of growth-enhancing structural reforms

Negative rating-change drivers

- Protracted fiscal deterioration results in weaker debt sustainability
- Fading commitment to or a reversal of structural reforms, leading to markedly lower GDP growth

Ratings and Outlook

Foreign currency

Long-term issuer rating BBB+/Positive

Senior unsecured debt BBB+/Positive

Short-term issuer rating S-2/Positive

Local 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

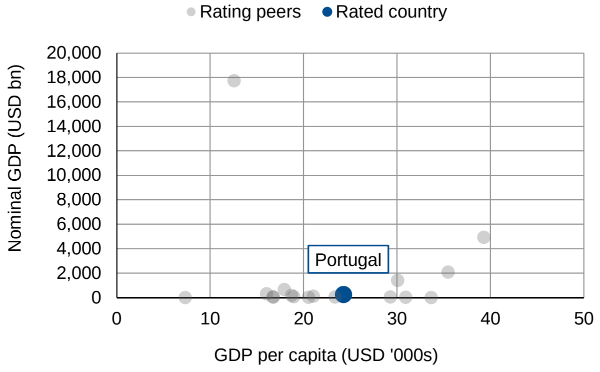
Domestic Economic Risks

- **Growth outlook:** After a severe decline of 8.3% of GDP in 2020, worse than euro area average (6.4%), the Portuguese economy returned to pre-pandemic levels in Q2 2021 and grew by 5.5% annually last year. The growth was driven by a strong recovery in private consumption, goods exports and public investments boosted by NGEU funds. International tourism, accounting for around 17% of Portugal's GDP, also started to recover in H2 2021, regaining almost pre-pandemic levels. We expect real growth of 6.5% in 2022, followed by a slow down to 1.3% in 2023 and a recovery around 2.1% in 2024. Economic growth will be impacted by the Russia-Ukraine war mostly through higher inflation, which is eroding households' purchasing power, reducing private consumption, and hampering investment. The Recovery and Resilience Plan, through which Portugal is set to receive EUR 13.9bn in EU grants and EUR 2.7bn in loans by 2026 will be the key contributor to the enhancement of the economy's growth potential, currently at 1.8%, inhibited by low productivity gains and the country's vulnerability to shocks in view of an uncertain global environment.
- **Inflation and monetary policy:** HICP inflation reached 9.8% YoY in September 2022, driven by increasing energy prices by almost 15% YoY in the same month, although remaining below the euro area average increase (21%). Similarly to Spain, Portugal has a low reliance on Russian energy and a temporary price cap on natural gas, resulting in lower electricity bills for a notable share of Portuguese and Spanish consumers with regulated rates. The Portuguese government expects to make up those costs through additional levies on energy companies' windfall profits. However, inflationary pressures broadened to other components such as transports, restaurants and hotels, pushing core inflation up to 6.9% in September.
- **Labour markets:** Government job retention schemes helped contain the pandemic's impact on the labour market. The seasonally adjusted unemployment rate has recovered to pre-pandemic levels by mid-2021, on the account of higher employment. We expect the unemployment rate to remain stable at 6% in 2022 – from 6.6% in 2021 – and then to increase to 6.3% in 2023.

Overview of Scope's qualitative assessments for Portugal's *Domestic Economic Risks*

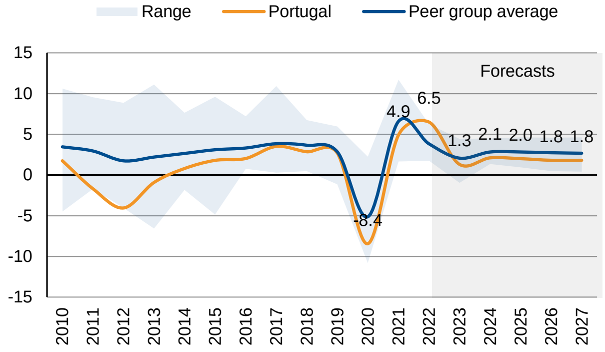
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Weak	-1/3	Moderate growth potential despite a significant wealth gap versus euro area peers
	Monetary policy framework	Neutral	0	The ECB is a credible and effective central bank
	Macro-economic stability and sustainability	Weak	-1/3	Limited diversification; low share of high-value added sectors

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

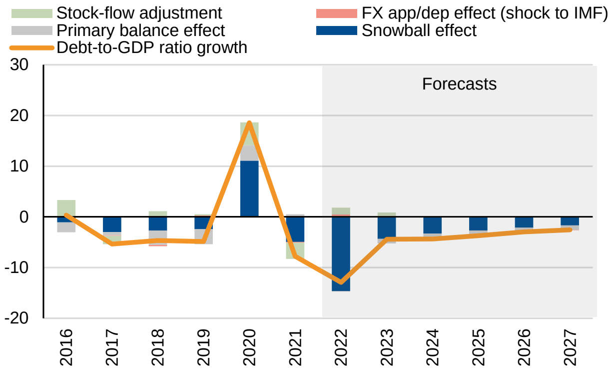
Public Finance Risks

- **Fiscal outlook:** We expect the general government deficit to gradually decline to 1.9% in 2022 – supported by revenue growth bolstered by inflation, alongside the unwinding of Covid-related measures – and to 1.3% in 2023. The public sector accounts' surplus of 0.8% of GDP recorded in the first six months of this year has helped creating fiscal space to adopt additional support measures in the second part of the year, without compromising the annual 1.9% fiscal deficit target. The government's parliamentary absolute majority bolsters credibility to realise fiscal consolidation, supported by the country's good record of primary surpluses in recent years, with an average primary surplus of 1.85% of GDP over 2015-19 and a reduction in the primary deficit to 0.5% in 2021 (from 3.1% in 2020). In the 2023 Draft Budget, the government confirmed its commitment to fiscal discipline, targeting a fiscal deficit of 0.9% of GDP. Medium-term fiscal pressures could emerge if inflation will remain high for a prolonged period.
- **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 134.9% of GDP in 2020, the downward trend resumed in 2021, when the debt-to-GDP ratio declined to 125.5%. A conservative fiscal management will support a gradual return to primary surpluses and a steady downward debt trend. We expect the debt-to-GDP ratio at 114.5% in 2022, on the back the economic rebound and high inflation, to decline to 96.5% of GDP by 2027.
- **Debt profile and market access:** Portugal benefits from strong market access, with the cost of outstanding debt on a steady declining trend in recent years, at 1.9% of GDP in 2021, down from 4.1% in 2011. Average debt maturity stood at around 7.6 years as of August 2022. Cash buffer remains at a comfortable level in 2022, covering almost 1/3 of gross financing needs.

Overview of Scope's qualitative assessments for Portugal's *Public Finance Risks*

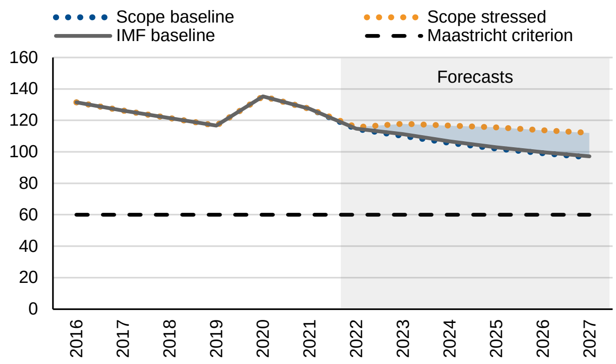
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Neutral	0	Good record of prudent fiscal policy, including elevated primary surpluses prior to Covid-19 shock
	Debt sustainability	Neutral	0	Downward debt trajectory expected, although debt is likely 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, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

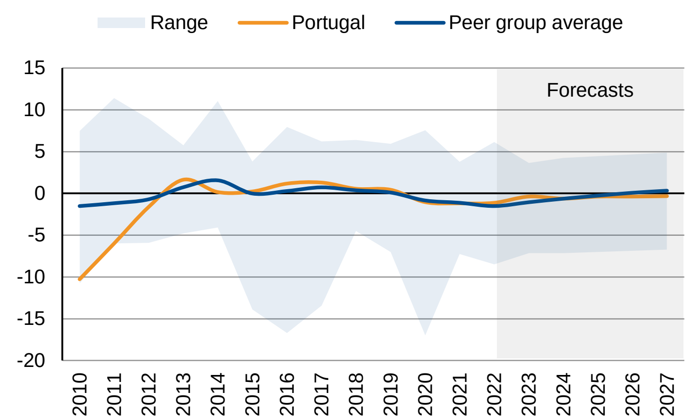
External Economic Risks

- **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 sharp fall in receipts from foreign tourism and related passenger transport services. Goods exports recovered last year thanks to the strong rebound in external demand and higher import prices, although they are expected to slow down this year due to the persistence of supply-side bottlenecks, persistent inflationary pressures and lower external demand. Direct trade exposure with Ukraine or Russia is low (accounting for 1.7% of total imports and 0.4% of total exports).
- **External position:** The large negative NIIP improved to -94.7% in 2021 from -104.6% in 2020 and it is expected at -84.5% in 2022, continuing to improve over the medium-term. 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 200% of GDP as of end-2020 to 168.9% as of April 2022. General government accounts for the highest share of foreign debt (33.1% as of April), followed by the Central bank (25.4%) and other financial institutions (15.1%).
- **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 small 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 Scope's qualitative assessments for Portugal's *External Economic Risks*

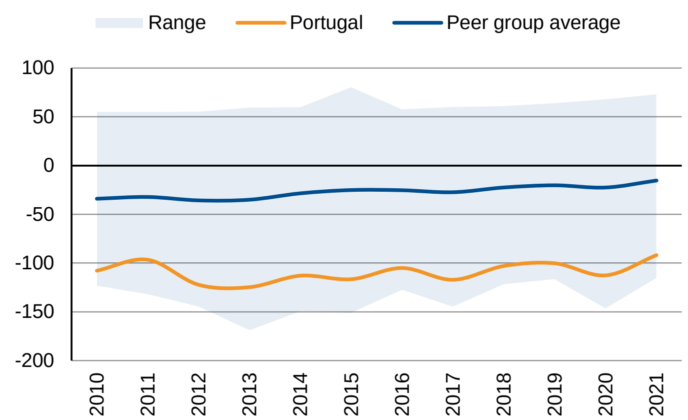
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Weak	-1/3	Dependence on tourism sector may temporarily weaken external trade
	External debt structure	Neutral	0	Elevated debt stock, with meaningful shares held by the government and central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

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

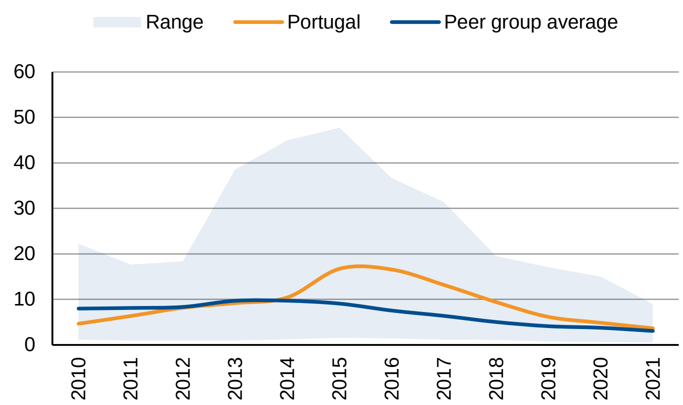
Financial Stability Risks

- **Banking sector:** The Portuguese banking sector has remained stable throughout the pandemic, maintaining comfortable liquidity (liquidity coverage ratio of 262% at Q2 2022) and adequate capital buffers (CET1 ratio at 14.1% as of Q2 2022). Non-performing loan (NPL) ratios steadily declined from the peak of 20% reached in 2016 to 3.3% in Q2 2022, thanks to policy support, NPL sales and write-offs.
- **Private debt:** Non-financial corporate (NFC) debt increased during the pandemic and reached a peak of 108.6% in Q1 2021 (BIS), mostly driven by Public Guarantee Schemes which ensured firms' liquidity and encouraged lending to NFCs. Household indebtedness as measured by the debt-to-disposable-income ratio increased moderately in 2021 by 1pp compared to the previous year and stood at 97% as of end-2021, below the euro area average. Banco de Portugal expects the savings rate to decrease to 6% on average over the medium term, reflecting the partial downsize of households' wealth accumulated during the pandemic.
- **Financial imbalances:** Rising interest rates are likely to contribute easing pressures on the real estate market, although according to Banco de Portugal, a sharp price correction in house prices seems unlikely. However, certain segments of the market create substantial volatility, such as those that are linked to demand from non-residents or associated with tourism.

Overview of Scope's qualitative assessments for Portugal's *Financial Stability Risks*

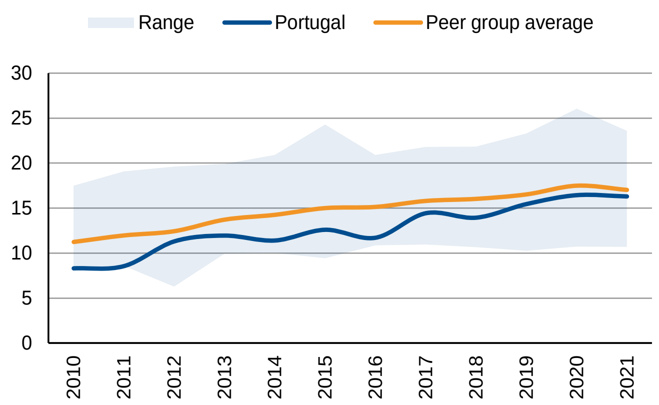
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound but NPL ratio remains high compared to peers
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union authorities and Banco de Portugal
	Financial imbalances	Neutral	0	Low savings and moderate private indebtedness; challenges to private sector debt service

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

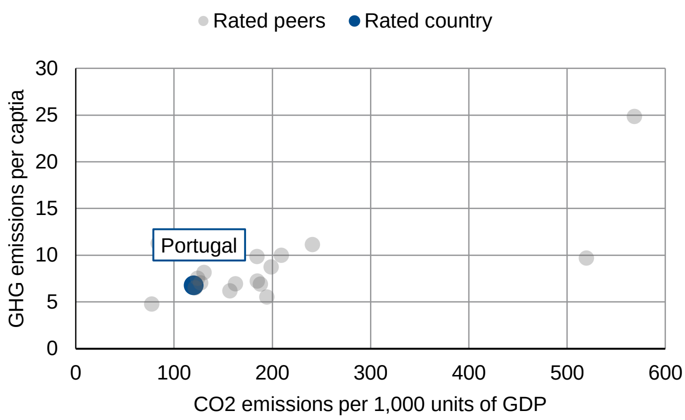
ESG Risks

- **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. Challenges are related to Portugal's high energy import dependency. The country is still highly reliant on imported fossil fuels, representing 69% of gross inland energy consumption in 2020. Energy dependence from Russia, however, is lower, as the share of Russian natural gas was 10% as of 2020 and only liquified. 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 (22.4% in 2021, increased from 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 Scope's qualitative assessments for Portugal's *ESG Risks*

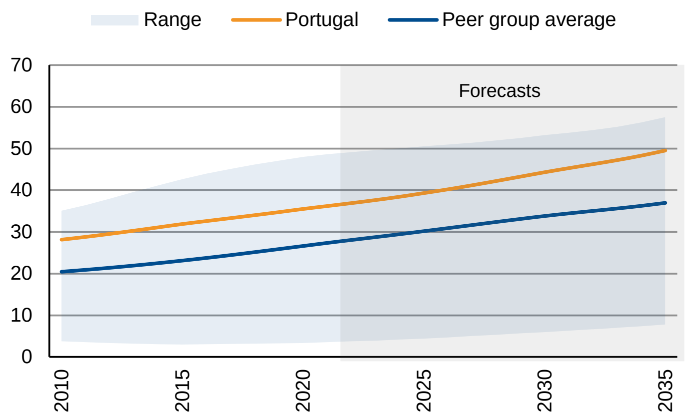
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Environmental risks	Neutral	0	Exposure to natural disasters, ambitious commitment to achieve carbon neutrality by 2050
	Social risks	Weak	-1/3	Adverse demographics; income inequality and risk of social exclusion
	Institutional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

Emissions per GDP and per capita, $mtCO_2e$



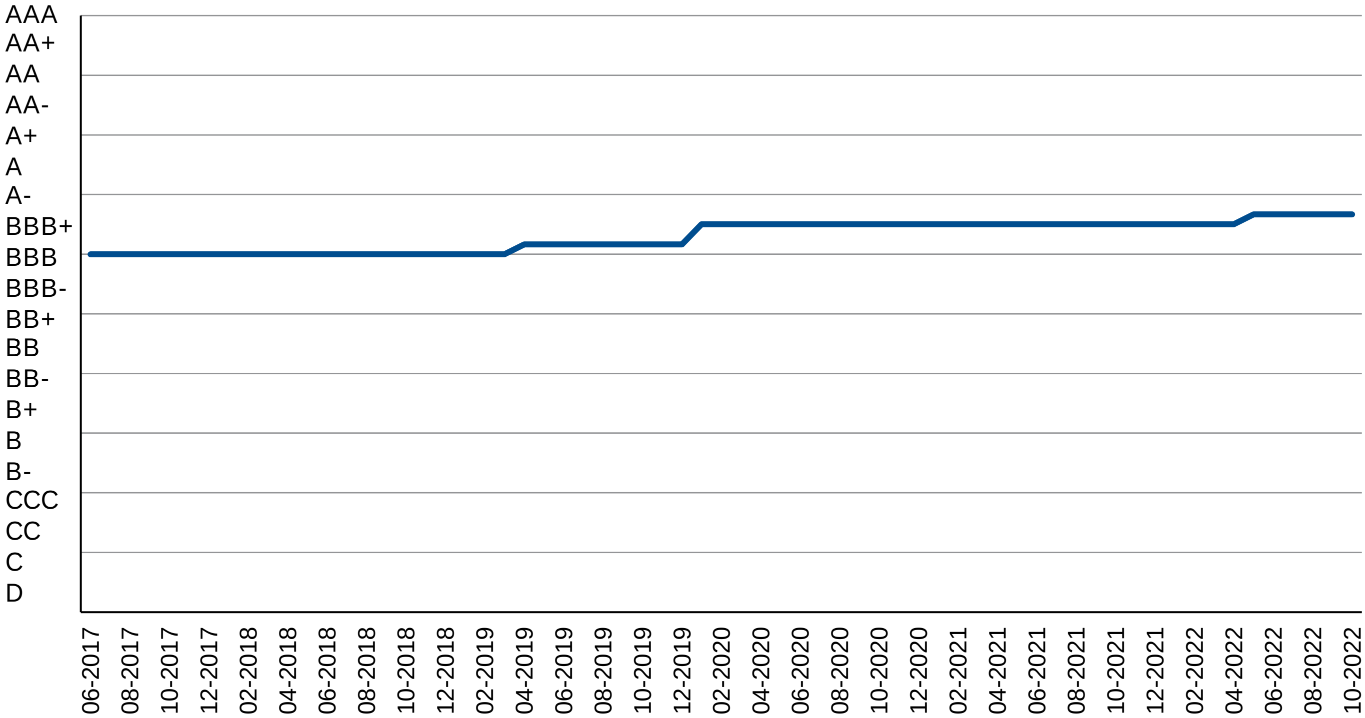
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

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, including a methodological reserve-currency adjustment.

Peer group*
China
Croatia
Cyprus
Hungary
Italy
Japan
Latvia
Lithuania
Malta
Poland
Slovakia
Slovenia
Spain

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

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	21,483	23,573	23,333	22,177	24,296
	Nominal GDP, USD bn	IMF	221.3	242.4	240.0	228.4	250.1
	Real growth, %	IMF	3.5	2.8	2.7	-8.4	4.9
	CPI inflation, %	IMF	1.6	1.2	0.3	-0.1	0.9
	Unemployment rate, %	WB	8.9	7.0	6.5	6.8	6.6
Public Finance	Public debt, % of GDP	IMF	126.1	121.5	116.6	135.2	127.4
	Interest payment, % of revenue	IMF	8.5	7.5	6.6	6.4	5.1
	Primary balance, % of GDP	IMF	0.7	2.9	2.9	-3.1	-0.5
External Economic	Current account balance, % of GDP	IMF	1.3	0.6	0.4	-1.0	-1.2
	Total reserves, months of imports	IMF	2.9	2.5	2.5	3.5	3.1
	NIIP, % of GDP	IMF	-117.2	-103.1	-100.3	-112.7	-92.0
Financial Stability	NPL ratio, % of total loans	IMF	13.2	9.4	6.2	4.9	3.7
	Tier 1 ratio, % of RWA	IMF	13.2	14.2	14.8	15.3	16.2
	Credit to private sector, % of GDP	WB	102.6	97.0	90.3	101.2	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	164.2	148.1	130.9	120.3	112.0
	Income share of bottom 50%, %	WID	18.9	19.5	19.6	20.0	20.0
	Labour-force participation rate, %	WB	74.9	75.4	75.8	-	-
	Old-age dependency ratio, %	UN	33.3	34.0	34.7	35.5	36.2
	Composite governance indicators*	WB	1.1	1.1	1.1	1.0	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 28 October 2022	62

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