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Rating Action

Neuss, 09 September 2022

Creditreform Rating has revised its outlook on the Portuguese Republic to positive from stable and affirmed the unsolicited long-term sovereign rating of "BBB". Creditreform Rating has also affirmed Portugal's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "BBB".

The outlook revision on the Portuguese Republic reflects

- (i) growing confidence over a relatively robust macroeconomic backdrop over the medium-term, with current strains due to geopolitical developments expected to have a limited impact, amid improved labor market performance, recovering tourism and ongoing investment bolstered by funds via NextGenerationEU and the Multiannual Financial Framework (MFF) 2021-27;
- (ii) an improved outlook for coherent policy formulation given the governmental majority in parliament, in our view strengthening prospects for the Recovery and Resilience Plan (RRP) to be implemented in a timely manner; and
- (iii) more favorable prospects regarding debt sustainability on the back of the expected decline of the public debt ratio, also buttressed by better-than-expected budget execution and by a higher degree of banking sector resilience.

Key Rating Drivers

1. Prospectively solid economic growth trend amid rebounding tourism and robust investment activity benefiting from substantial EU funding; while domestic demand and tourism look set to remain supportive factors, increased economic uncertainty due to the geopolitical tensions and cost pressure via higher commodity prices are likely to weigh on the real GDP performance in the near term; risks related to new virus mutations appear rather remote, although implying some downside risks to the important tourism sector
2. Medium-term growth outlook remains favorable, with progressing implementation of measures and investment set out in the RRP expected to improve hitherto low productivity growth and lagging innovation potential; political backdrop resulting from latest general election constructive with a view to prospects for the implementation of structural reform agenda; pockets of vulnerability in light of elevated private debt

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3. High quality of the institutional framework, buttressed among other things by advantages regarding market access, funding and common standards entailed by EU/EMU membership; despite improvements, some challenges remain with regard to the efficiency of the justice system, as well as concerning the combat and prevention of corruption; January's snap election resulting in outright majority, likely to contribute to positive context for coherent policy formulation and implementation
4. High public debt and risks to fiscal sustainability remain in place, despite better-than-expected fiscal performance last year and a marked drop in the public debt ratio; while the near-term outlook remains subject to downside risks linked to negative reverberations from Russia's aggression against Ukraine, we still expect debt-to-GDP to decline over the medium term; contingent liabilities are on the decline but may have to be monitored; negative repercussions from a high level of private sector indebtedness in the context of tightening monetary policy and a more challenging macroeconomic environment would meet with an increasingly resilient banking sector
5. Portugal's status as a pronounced net international debtor comes with some vulnerabilities, but the net international investment position (NIIP) has improved further and its composition mitigates risks somewhat; while current account should remain in deficit this year, the deficit could shrink in 2023 amid further recovering tourism and an expected moderation of commodity prices

Reasons for the Rating Decision and Latest Developments¹

Macroeconomic Performance

Our credit assessment continues to reflect a solid macroeconomic performance profile buttressed by Portugal's comparatively wealthy economy. Interrupted by the corona crisis and its heavily negative impact on tourism, economic growth rebounded from the second half of last year, boosted by recovering tourism, but came to a halt in the second quarter of 2022 amid fallout from the war in Ukraine. Labor market metrics have improved alongside the recovery, but seem to have stabilized more recently, with some structural challenges still to be dealt with, notwithstanding advancements in this regard. The medium-term growth outlook remains constructive on the back of substantial EU funding that will partly finance the initiatives and investment envisaged in the RRP. While prospects for enhanced productivity remain positive, a relatively high level of private indebtedness could pose some constraints to economic growth in the medium term, limiting shock-absorbing capacities.

The Covid-19 pandemic disrupted a phase of above-euro-area-level GDP growth (2015-19: 2.6%, euro area: 2.0%), pushing real economic output down by 8.4% in 2020 (euro area, EA: -6.3%). The sharp decline was not made up for by the following recovery in 2021, when real GDP expanded by 4.9% (EA: 5.3%). Last year's economic rebound was buoyed by private consumption amid easing of pandemic-related restrictions, contributing 3.0 p.p. to the GDP growth outcome. Gross fixed capital formation also added positively to the overall output expansion (1.2 p.p.), boosted by broad-based investment increases. While public consumption supported the GDP outcome as well, net exports posed a drag. However, boosted by increasing tourism-related

¹ This rating update takes into account information available until 02 September 2022.

receipts, to a lesser extent also by ICT-related services, overall service exports increased by 21.3% in 2021, although remaining well below levels registered prior to the outbreak of Covid-19 (Eurostat, BPM6 data).

Drawing on IMF data, Portugal's GDP per capita stood at roughly USD 36,844 last year (current prices, PPP), resuming its rising trend after the brief reversal in 2020. This said, as set against the EU income level, Portugal has lost some ground through the pandemic, stabilizing at about 76% of the EU level in 2021 after decreasing in the first year of the corona crisis.

In quarterly terms, the uninterrupted expansion in total economic output from Q2-21, significantly supported by recovering tourism, came to an end in Q2-22 when GDP only stagnated compared to the preceding quarter. Nevertheless, thanks to its strong growth in this year's first quarter, real GDP finally exceeded its pre-pandemic level (Q4-19).

Looking ahead, tourism is set to remain a decisive growth-supporting factor. Drawing on INE data on overnight stays, we observe that in the first half of 2022 the number of non-resident overnight stays increased by 529.5% compared to the same period last year. Nevertheless, it remained somewhat below levels registered in the first six months of 2019 (-11.9%). On a more positive note, in terms of total revenue in tourist accommodation establishments, Portugal recorded an increase of 308.1% from Jan-Jul-22 compared with the respective interval in 2021, exceeding the respective level in 2019 by 4.8%.

Given persistent increases in commodity prices and shortages of materials and equipment, the latter partly exacerbated by zero-Covid-policies in China, the near-term outlook for macroeconomic developments in Portugal has clouded, notwithstanding comparatively limited direct trade links with Russia and Ukraine. However, some of Portugal's European trading partners display higher exposure, likely hampering Portuguese export prospects. As regards Portugal's dependency on fossil fuels, oil and petroleum products account for the bulk of Portugal's energy mix, coming to about two fifths of gross inland consumption in 2020 (41.8%, Eurostat), whereas oil (and oil products) imports from Russia had fallen to about 4% of total oil imports in 2020 (2019: 10.6%).

This said, Portugal is feeling the pinch from higher energy prices, which have contributed decisively to pushing the inflation rate (HICP) to 9.4% in Aug-22. With regard to recent business climate indicators, export expectations deteriorated in the first half of the current year. Judging by the European Commission's (EC) Economic Sentiment Indicator, the mood among businesses deteriorated for a third consecutive month in Aug-22. That said, sentiment in the service and retail sectors edged up somewhat in August, while consumer confidence appears to be bottoming out after plunging in March.

Private consumption will likely be hampered by high consumer prices, but expected unwinding of savings, the generally solid labor market situation and measures by the government to mitigate the effect of rising energy prices should provide vital support. Overall, we expect household expenditure to continue to contribute positively to GDP growth, benefiting from tailwinds from the second half of 2021 and this year's first quarter. A comparatively high inclination of the population to receive Covid-19 inoculation, as mirrored in one of the highest vaccination rates among the EU members (uptake of the primary course, ECDC), should help to contain risks emanating from further virus mutations.

Whilst the Russian war against Ukraine and related repercussions could result in the postponement of investment projects, we assume gross fixed capital formation to expand robustly in the

near- and medium term, also driven by EU financing. Several public investment projects as regards e.g. public transport and the health sector are already underway. Apart from grants over EUR 13.9bn and EUR 2.7bn in loans via the Recovery and Resilience Facility (RRF), Portugal stands to receive about EUR 33.6bn in grants via the Multiannual Financial Framework (MFF) 2021-27. Moreover, as per the State Budget 2022, companies are incentivized (Tax Incentive for Recuperation, IFR) to make use of tax reductions for new investments in the second half of 2022.

At the same time, the geopolitical circumstances and shortages of materials pose headwinds to the near-term outlook, as also suggested by the Fast and Exceptional Enterprise Survey (IREE, BdP, Jun-22), reflecting companies' affected sentiment in light of rising production costs and supply bottlenecks. Prospects of further deteriorating financing conditions on capital markets amid tighter monetary policy add to factors potentially dampening the growth outlook for investment.

On the back of the strong second half of 2021 and particularly vivid growth in this year's first quarter, service exports may well turn out to become the primary driver for GDP growth this year. Net exports should thus contribute significantly to the anticipated GDP expansion this year, while we would expect the boost via this component to decrease in 2023.

At this stage, we expect real GDP to expand by about 6.3% in 2022, lifted considerably by a carry-over effect from 2021 (~3.7 p.p.). Against the backdrop of the rather muted quarterly growth profile we expect for the second half of the year and the beginning of 2023, we currently forecast GDP growth to slow significantly to 2.0% in 2023.

With a view to medium-term output expansion, the previous above-average absorption rate of ESIF funds (2014-2020) and a governmental majority in parliament seem to bode well for a timely roll-out of the funds and further progressing implementation of the RRP measures. That said, the first RRP instalment was not disbursed until May-22, amounting to EUR 1.16bn, likely owing to political volatility, which resulted in parliament's rejection of the initial state budget 2022 and subsequent snap election at the end of January (see also below). We gather that, as of 10 August, about EUR 762mn has been paid out to final beneficiaries (Recuperar Portugal), while investments in the amount of about EUR 6.5bn had been approved.

The largest chunk of the RRF funds (37.9%) is allocated to climate objectives, while 22.1% is to be directed towards the digital transformation, with digitalization of the public administration and SMEs, as well as in the educational field, among key investment targets. As part of the update of the Strategy for Technological and Enterprise Innovation 2018-30, R&D and innovative investment are to be fostered. The respective document was adopted in Dec-21 (EC intelligence), laying the ground for further advancements in terms of innovation, especially among SMEs, as well as in sectors such as the ocean-based economy, agriculture and bio-economy, which could prove conducive to lifting Portugal's productivity.

When it comes to nominal productivity per person and per hour worked as percentages of the EU-27 level, Portugal has witnessed a deteriorating trend over recent years, standing at 71.7% and 64.1% in 2021, respectively. In terms of growth of real labor productivity per person and per hour worked, Portugal was roughly aligned with the respective average growth registered in the euro area over 2015-19, while comparing less favorably in the exceptional years 2020 and 2021.

With money already flowing into transport infrastructure projects (see above), Portugal's capital stock thus looks set to contribute decisively to potential growth over the next few years, flanked by TFP growth. Current estimates put the sovereign's potential growth at 2.0% for 2022 and 2023

(AMECO data), markedly above its long-term average since inception of the euro (1.1%, EA: 1.4%) and in excess of the average over the period 2015-19 (1.2%, EA: 1.2%).

In tandem with an aspired-to higher degree of digitalization in many areas, the RRP strives to promote a more business-friendly environment as well as a higher degree of efficiency in the judicial sector, in particular as regards administrative cases and insolvency procedures, in a bid to enhance Portugal's non-cost competitiveness.

Portugal occupied one of the lower ranks among the EU members in the 2022 IMD World Competitiveness Yearbook, being placed in 42nd rank out of 63 economies considered (2019: rank 39). In this vein, the EC's assessments hint at regulatory red tape limiting competition (SME performance review) and still prevalent shortcomings with a view to the efficiency of its justice system (Justice Scoreboard). Looking at the EC's 2022 Digital Economy and Society Index, Portugal's rank of 15 among the EU members, edging up from rank 16 compared to last year's edition, seems to point to some room to catch up. We note that as far as integration of digital technology in business activities is concerned, Portugal has improved by five places vis-à-vis last year's ranking (rank 12 in 2022).

In the context of recent sluggish productivity growth, especially in terms of real labor productivity per person as compared to its main trade partners, we observe that real unit labor costs have developed somewhat less favorably of late, as real compensation per employee had grown considerably stronger than productivity for several years prior to the pandemic. If real ULC deteriorate further, Portugal may experience some erosion of its competitive stance at some point.

The decrease by 0.05 p.p. to 0.38% in 2020 was chiefly due to collapsing tourism, heavily bearing down on the global market share of service exports, which dropped by 0.14 p.p. to 0.51%. Some recovery took place in 2021 (services: 0.54%), although not yet making up for the losses incurred in the first year of the pandemic. The global export market share concerning goods has remained rather stable, as has the overall export market share in 2021 (0.38%).

Portugal's labor market has shown resilience over the pandemic. The annual unemployment rate decreased by 0.4 p.p. to 6.6% in 2021, cushioned by extended fiscal support for workers' income (AERT). With that, unemployment even fell to slightly below its 2019 average (6.7%), posting below the rate registered for the euro area as a whole (2021: 7.7%, Eurostat). More recently and looking at monthly figures, the jobless rate dropped further to 5.7% in Feb-22 before starting to inch up, recording 5.9% in Jul-22.

Moreover, the labor participation rate continues to compare favorably against the euro area level, standing at 76.1% as of Q1-22 vs. 74.6% in the euro area. Also, we think that the swift recovery in employment, which in 2021 stood above its 2019 average pays testament to strengthening economic resilience and effective crisis management. We note that the ICT sector continued to see particularly strong job creation, with employment increasing by 14.8% in 2021. Further employment increases in ICT, as well as in public administration in Q1-22 (Eurostat data, domestic concept), tie in with the abovementioned aspirations to step up the implementation of government policies.

Looking at some of the longer-standing shortcomings on the labor market, youth unemployment resumed its downward trend after being pushed up in the first year of the pandemic. However, at 19.3% it remains well above the rate recorded for the euro area overall (Jun-22: 13.6%). Further to some structural deficiencies, at 33.7% the share of the low-skilled labor in

employment was the highest in the EU (ISCED 2011 levels 0-2, 15-64 years, Q1-22). To be sure, both issues are being addressed by initiatives included in the RRP.

Factors potentially weighing somewhat on the medium-term outlook include the comparatively high level of private indebtedness, also bearing in mind relatively high proportions of loans subject to variable interest rates against the backdrop of tightening monetary policy (see below). Non-financial corporate (NFC) debt stood at 92.4% of GDP as of Q1-22 (Q1-21: 97.3%, Q4-19: 87.4%), ranging among the higher ratios among EU members.

Having been in negative territory prior to the pandemic, annual growth rates of banks' outstanding loans to NFCs had seen strong increases in the initial stages of the pandemic while flattening somewhat more recently. As of Jun-22, NFC loans increased by a more moderate 1.7% y-o-y (Jun-21: 7.2%, Dec-19: -3.7%). In this context, it seems worth mentioning that the debt level of state-owned NFCs resumed its upward trend over the year to May-22 (BdP data). That said, we are aware that, in order to address vulnerabilities in state-owned enterprises (SOEs), a new management contract template has been in force since Dec-21, with the aim to strengthen governance of SOEs.

In terms of household debt measured against disposable income, the sovereign moves in the middle-range among the EU countries, posting at 94.1% as of Q1-22. Given that mortgage debt represents a substantial part thereof, and given increased dynamics of mortgage lending, developments remain to be monitored (see below).

We recall that, following credit moratoria which had been in place from Mar-20 until the end of 2021, a capitalization fund with a firepower of EUR 1.3bn via Banco Portugues de Fomento (BPF) was established to avoid any cliff edge upon expiry of the payment breaks. According to BdP data, 0.1% of total loans to the private sector were subject to moratoria as of Nov-21, with 1.4% of loans to NFCs, down from a peak at 34.1% in Aug and Sep-21. As of 1 July 2022, BPF had approved applications from 12 companies for a total amount of about EUR 77mn.

Institutional Structure

The sovereign continues to feature a very strong institutional framework, including the advantages associated with being a member of the EMU and EU, especially for a small open economy such as Portugal. Apart from access to substantial EU funding, inter alia via the MFF and RRF, Portugal thus benefits from the single market and respective common standards. The sovereign has also demonstrated a high degree of responsiveness to recommendations by institutions such as the IMF and EC following the global financial crisis and the euro debt crisis. Given that January's snap election yielded an outright majority for the governing Socialist party, which previously headed two minority governments, we think that prospects for a timely implementation of the RRP should have improved. Meanwhile, notwithstanding progress, some challenges related to the efficiency of the judicial system and concerning full implementation of measures to combat and prevent corruption remain to be tackled.

While awaiting the annual update of the World Bank's Worldwide Governance Indicators (WGIs) due in September and referring to 2021, latest available data referencing 2020 as base year generally corroborate our assessment of the sovereign's very high institutional quality. We thus observe that, with respect to three of the four dimensions on which we put high emphasis, namely voice and accountability, rule of law and control of corruption, Portugal's respective ranks were little changed compared to the preceding year.

A slightly more pronounced change occurred with regard to government effectiveness, with the sovereign slipping six places to relative rank 40 (out of 209 economies), continuing a deteriorating tendency from 2018, although not remaining too far off the euro area median (rank of 35). A noticeably stronger assessment than compared with the euro area median can be observed when it comes to the WGI voice and accountability, with respect to which the sovereign improved to relative rank 20 out of 209 (EA median: 33), up from rank 25. Although staying in sight of the euro area median (rank 43), Portugal displays a somewhat weaker rank 49 concerning corruption perception (WGI control of corruption, 2019: 48).

Somewhat tying in with the latter, the Group of States against Corruption (GRECO) in its annual report covering 2021 pointed to Portugal having fully implemented only three of 15 recommendations at the time. This said, implementation of the National Anti-Corruption Strategy 2020-24 is underway, and 2021 saw a national anti-corruption mechanism being established.

Concerning the judicial system, we assess as positive steps taken to improve on the comparatively long time it takes Portuguese courts to resolve administrative cases at the first instance, as recently underscored by the EC's 2022 Justice Scoreboard. At the same time, authorities remain determined to address identified shortcomings, e.g. by introducing rapid reaction teams with respect to administrative and tax court cases, strengthening human resources, and enhancing efficiency of insolvency and civil enforcement proceedings.

The creation of specialized chambers in higher administrative and tax courts to deal with the high backlog of cases counts among deliverables under the RRP for 2022 and 2023. Further key initiatives include a healthcare reform, also entailing enhanced possibilities for telemedicine, entry into force of the law on regulated professions (by the end of 2022), and a legislative package on reorganizing public administration, envisaged for 2023.

Turning to Portugal's political environment, the outright majority won by the Socialist party (PS) in the snap election on 30 January 2022 should be conducive to implementing government policies elaborated above in a timely fashion, as the likely greater political stability in our view will contribute to a positive backdrop for coherent policy formulation and implementation. The snap election had been called in November 2021 after the Communist and Left Bloc, which had backed Prime Minister Costa's (PS) minority government, voted against the government's draft budget 2022, along with the right-leaning opposition. The Socialist party obtained 120 of the 230 seats (41.4% of the votes) in the Assembly of the Republic, having been at the helm of minority governments since 2015. The Social Democrats (PSD) became the second-strongest force, obtaining 77 seats (29.1% of the votes), with the right-leaning Chega coming third (12 seats).

As far as greening the economy is concerned, Portugal continues to display a strong commitment to adhering to the climate goals in order to reach carbon neutrality by 2050. Due to its geographical and morphological characteristics, there are vulnerabilities in terms of exposure to physical risks from climate change, such as forest fires, more frequent droughts, and water shortages. Portugal's geographical characteristics also enable it to make use of hydropower and wind energy.

At about 34.0%, Portugal thus exhibited one of the higher overall shares of energy from renewable sources in the EU in 2020 (EU-27: 22.1%), particularly pronounced when it comes to renewable energy used in gross electricity consumption (58.0%). The country also ranks among the EU members with the lowest greenhouse gas emissions per capita in the same year. With regard to the EC's Eco Innovation Index, Portugal moves in the middle range among fellow EU states

(2021). While it is considered a laggard as far as waste management and the circular economy is concerned, there are efforts to improve on this, e.g. as set out in the National Waste Management Plan 2030.

Fiscal Sustainability

Portugal's credit ratings remain constrained by the very high, albeit declining, public debt ratio, which we expect to remain on a downward path in the near term, following its marked drop in 2021. Apart from an expected shrinking headline deficit despite heightened uncertainty due to the unfavorable geopolitical context, the likely high nominal GDP in 2022 should contribute to pushing down debt-to-GDP, with this effect assumed to weaken next year. Portugal's track record of fiscal consolidation in its recent history lends confidence for this to be repeated. Sound debt management, a high share of debt held by the official sector, a somewhat upward-trending average maturity of the debt portfolio and still comparatively low interest payments continue to represent risk-mitigating factors to fiscal sustainability risks. We will continue to closely follow effective implementation of the 2015 budgetary framework law, as well as developments of contingent liabilities, which have further diminished although from a somewhat elevated level. Asset quality continues to improve, with developments around mortgage lending to be monitored in a context of increasingly less affordable residential property and tightening monetary policy.

The pandemic-induced large general government deficit of 5.8% of GDP in 2020 was substantially reduced in 2021, coming in at -2.8% of GDP, significantly smaller than we had estimated in our last review (10 Sep-21: -4.6% of GDP). On the back of the economic recovery and phasing out of pandemic support measures, the increase in general government expenditure moderated to 3.0% (2020: +8.5%), aided by another large drop in interest payments as well as a slightly smaller rise in social benefits and consumption expenditure. Interest outlays declined by 10.8% last year, helping to shrink the interest-to-revenue ratio to 5.4% (interest-to-GDP 2021: 2.4%). Public wages, on the other hand, saw a somewhat stronger increase than in 2020, expanding by 4.0%. Gross fixed capital formation, meanwhile, continued to rise strongly (2021: 19.0%, 2020: +14.0%), underscoring commitment to strengthening Portugal's growth base.

On the revenue side, rebounding economic activity boosted the tax intake, illustrated among other things by an increase in tax income from production and imports by 10.6%, while net social contributions mounted by 6.0%. Overall, general government revenue leapt by 10.0% in 2021 (2020: -4.6%).

Looking at budget execution data for the current year until Jun-22, there is little sign of the negative repercussions from Russia's war in Ukraine amid positive surprises in particular regarding tax intake, although we expect this to increasingly feed through in light of the observed significant economic slowdown. From Jan-Jun-22, general government revenue saw a strong increase by 19.7% y-o-y in cash terms, driven by vividly growing tax receipts and social security contributions. At the same time, total government outlays fell by 1.7% y-o-y compared to the first half of 2021, again aided by falling interest payments and other charges (-15.3% y-o-y).

However, in light of soaring energy and other commodity prices, the government in May-22 approved a gas price ceiling for electricity production, intended to remain in place for 12 months. This adds to measures taken earlier such as the reduction in fuel tax, temporary subsidies to passenger transport and a fixed social benefit to cushion the blow to households and businesses, initially intended to expire in Jun-22. As of Jul-22, the overall budgetary effect from

measures agreed to mitigate the adverse effects from the hostilities in Ukraine, including spending on accommodation for refugees from the war-stricken country, was estimated to amount to roughly 0.7% of GDP (Ministry of Finance, MoF).

According to the Draft Budgetary Plan 2022 (DBP22), discretionary measures other than initiatives to cushion the impact of the war in Ukraine included a revision of the personal income tax brackets, resulting in some tax relief for families (0.1% of GDP) and remaining support in connection with Covid-19 (0.5% of GDP). Budgeted aid to the airline TAP amounts to about 0.3% of GDP.

Considering the latest developments, we currently estimate that this year's headline deficit could come to about 2.1% of GDP this year, while we expect a decrease to roughly 1.1% of GDP for 2023. We note that a new package of measures has been announced for September to support private households and businesses, highlighting uncertainty over this year's fiscal outcome. We would flag further risks to this year's fiscal outcome from the persistent drought in many parts of Europe including Portugal, potentially requiring further government support to alleviate the fallout for affected sectors as well as the further burden on consumers from higher agricultural and food prices.

Despite a more challenging backdrop, the government remains committed to consolidating public finances in the medium term, targeting a balanced budget in 2025 (Stability Program 2022, SP22) and a slight headline surplus in 2026. With regard to current geopolitical events, risks surrounding the medium-term fiscal outlook seem skewed to the downside, possibly exacerbated by some remaining uncertainty over further developments of the coronavirus. Apart from that, defense spending is to go up, currently envisaged to reach 1.89% of GDP in 2024.

Amid the rebounding economy and decreasing headline deficit, and partly thanks to the reduction of cash buffers, Portugal's debt-to-GDP ratio declined by 7.8 p.p. to 127.4% of GDP in 2021 (EA: 95.6% of GDP), returning to a downward path in place prior to the outbreak of coronavirus. Nevertheless, it remained the third-highest ratio among the EU members. As of Q2-22, the ratio had declined further to 126.7% of GDP. At this stage, we expect the public debt ratio to drop to 116.2% of GDP this year, partly aided by inflationary effects, and to shrink to 111.7% of GDP in 2023. In our current baseline scenario, debt-to-GDP would thus fall below its pre-pandemic level as early as 2022 (2019: 116.6% of GDP).

With regard to some structural features, we would reiterate the absence of a multi-annual fiscal budgeting, as also echoed by Portugal's Fiscal Council (CFP). Effective implementation of the 2015 budgetary framework law has dragged, although we would highlight as positive that the RRP envisages further headway in this respect. Adding to more positive aspects, vulnerabilities regarding governance of SOEs are addressed (see above), potentially contributing to the containment of any contingent liabilities arising from these.

Picking up on the latter, we note that, out of a maximum amount of Covid-19-related contingent liabilities of 5.06% of GDP, guarantees in the amount of 3.82% of GDP were estimated to have been taken up (SP22). Overall, public guarantees are expected to diminish to 7.83% of GDP in 2022, from 9.02% last year, thus remaining somewhat elevated. Only a very small fraction of these (0.01% of GDP) is linked to the financial sector.

Portugal's banking sector, which in terms of asset-to-GDP remains above its pre-pandemic level (Q1-22: 206.9% of GDP, Q4-19: 182.8%), has weathered the health crisis relatively well. Having gone up during the most acute phase of the corona crisis, banks' capitalization in terms of CET1

ratio has fallen back somewhat by Q1-22 (14.3%, EU: 15.2%, EBA data), but still exceeds levels registered in 2019. The NPL ratio suggests continued improvement in banks' asset quality, dropping to 3.5% by Q1-22, a multi-year low, although still noticeably above the EU average (1.9%).

That said, given its significant exposure to real estate and bearing in mind a comparatively large proportion of new mortgage loans with variable rates (Jun-22: 67.0%, ECB data), we would monitor how the banking sector fares in a context of monetary policy tightening, also given the rising dynamics as regards mortgage lending. Mortgage loans account for nearly half of the outstanding credit to the private sector (Jun-22: 48%, ECB data), and recently rising household debt was mainly driven by lending for house purchases. Banks' outstanding mortgage loans to households rose by 4.6% y-o-y as of Jun-22 (Jun-21: 1.3%, Dec-19: -0.2%).

At the same time, housing prices have continued to increase vividly (Q1-22: 12.9% y-o-y, 33.2% vs. Q1-19, Eurostat data), with a shortage of new housing supply contributing to mounting price pressure. The number and amount of residential property transactions grew by 7% and 24% compared to 2019 (BdP, Financial Stability Report Jun-22), pointing to a dynamic residential property market. Indicators such as the OECD's price-to-income ratio currently indicate some misalignments between prices and fundamentals, moving 22.0% above the long-term average (since 1995) in Q1-22.

By the same token, BdP sees some signs of overvaluation, although demand on the part of non-residents and tourists could play a larger role in this. In order to prevent mortgage dynamics from becoming a driver of house price developments, BdP has resorted to enhancing macroprudential recommendations. As of 1 April 2022, adjustments to the maximum maturity of new credit agreements for house purchases were made, aiming for convergence of the average maturity to 30 years by the end of 2022.

We continue to see Portugal's sound debt management as a mitigating factor to fiscal risks, added to by still highly affordable debt, a benign maturity structure and a solid investor base. While the average residual maturity of the debt portfolio has been relatively stable lately, coming to 7.7 years as of May-22 (IGCP), long-term issuances such as the 10-year benchmark bond syndication in Apr-22 (EUR 3bn, due in Jul-32) are likely to lengthen the average residual maturity, reducing refinancing risks further. The ECB has accumulated Portuguese government bonds in the amount of about EUR 90.7bn under its PSPP and PEPP (or about 32.9% of general government gross debt as of Q1-22).

More generally, the high share of government debt held by the official sector, amounting to 53% as of Q4-21 (foreign official sector, domestic central bank, IMF data), adds to the alleviation of fiscal sustainability risks. In this context we note that, of the EUR 2.7bn EFSM loan due in April 2022, Portugal repaid EUR 0.5bn, while the remaining EUR 2.2bn was rolled over to 22nd October 2026 with the further repayment schedule to be reviewed as agreed between Portugal and the EFSM.

Cost of issuance, meanwhile, has begun to turn, rising to 1.2% as of Jul-22 (2021: 0.6%, IGCP), illustrating that market financing conditions are tightening. The yield on 10-year Portuguese government bonds has trended upward throughout this year, dropping back to 2.30% as of 19-Aug-22 after peaking at about 2.80% in June (weekly data), with the spread to German 10-year government bonds at a still relatively moderate level at about 107bp. For the first time since 2011, the ECB raised its key policy rates this July by 50bp and approved the Transmission Protection Instrument as a new addition to its toolkit. The latter will focus mainly on euro area public

sector securities purchases, subject to certain conditions and aiming to deflect unwarranted, disorderly market dynamics which could potentially hamper monetary policy transmission. Given protracted price pressure and a broad tightening of labor markets, we regard a further increase of the refinancing rate as increasingly likely, to 1.50% by the end of this year.

Foreign Exposure

As a small open economy, Portugal remains prone to external shocks, and its pronounced net external debtor position continues to pose a credit vulnerability. We acknowledge that there have been further improvements and the composition of its net international investor position mitigates risks to some extent. Tourism has seen a more vivid recovery as of late, limiting the impact of the surge in commodity prices on Portugal's current account, which turned into a deficit in the wake of the pandemic.

After a transitory setback reflecting Portugal's plunging GDP, its negative NIIP narrowed markedly in 2021, by 8.9 p.p. to -95.9% of GDP, continuing an improving trend over recent years. The ratio decreased further to -92.8% of GDP as of Q1-22. With this, the sovereign still displays one of the most pronounced net international debtor positions among the EU countries. Last year's development was primarily driven by improving net portfolio investments (+7.6 p.p. to 14.1% of GDP), although we note that favorable valuation effects appear to have played an important role. With the negative net foreign direct investment position accounting for almost half of the overall NIIP position, mostly on the back of incoming direct investment over the last few years, an important risk-mitigating factor remains in place. Overall, the NIIP, excluding non-defaultable instruments (NENDI), has shrunk to -36.6% of GDP last year (2019: -46.7% of GDP).

Meanwhile, Portugal's current account balance remained in deficit in 2021 and roughly stable in terms of GDP compared to 2020 (-1.1% of GDP), having exhibited an average surplus of 0.7% of GDP in the years from 2015-19. Despite a recovery in tourism in the second half of 2021, the surplus in the service balance was still only roughly half of what it had been prior to the pandemic (2021: 4.5% of GDP, 2019: 8.4% of GDP). More recently, the current account deficit rose to 1.7% of GDP (Q1-22, four-quarter moving sum), with the larger goods deficit more than offsetting a higher services surplus.

We expect this pattern to broadly continue in 2022 before an anticipated moderation in commodity prices could allow the current account to move towards a balanced position in 2023. As risks related to the Covid-19 pandemic currently appear more remote, we expect the rebound of tourism to continue next year, adding to the anticipated reversal in the current account balance.

Rating Outlook and Sensitivity

Our rating outlook on Portugal's long-term credit ratings is positive, as we assume that the risk situation will improve over the next 12-24 months. Expectations that spillovers on the macroeconomic outlook from current geopolitics will be limited, improved prospects for RRP-reform implementation in a timely manner in light of a majority-backed government, and Portugal's very strong institutional set-up outweigh risks to fiscal sustainability, which we consider to be somewhat reduced going forward. We continue to emphasize that the assessment and interpretation of economic developments remains more challenging than under normal circumstances, as is the case for other indicators, in particular from the fiscal realm.

We could consider raising the sovereign's ratings if economic growth continues, with the most recent dent remaining short-lived, avoiding any sustained negative consequences for public finances, thus enabling the envisaged downward path for the public debt ratio. Upward pressure on the ratings could also arise from tangible signs of strengthening productivity, possibly amid swift progress in implementing the RRP initiatives.

As opposed to that, a negative rating action could be prompted by a substantial deterioration of the economic growth outlook, possibly as geopolitical tensions escalate further, and a related significant worsening of fiscal metrics, reversing prospects of a downward-sloping public debt path. A pronounced deterioration of asset quality in the banking sector amid businesses and consumers facing difficulties servicing their debt, possibly adding to contingent liabilities, could also lead to a downward revision of our outlook or the ratings.

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Ratings*

Long-term sovereign rating	BBB /positive
Foreign currency senior unsecured long-term debt	BBB /positive
Local currency senior unsecured long-term debt	BBB /positive

*) Unsolicited

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook. For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to

the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

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ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demo-graphics	
Labor	Equality	Technology & Infrastructure	Safety & Security	Judicial System	Quality of Public Services	
Integrity of Public Officials	Quality and Efficacy of Regulations	Civil Liberties/ Political Participation	Market Access	Business Environment	Data Transparency	
Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank’s Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating’s assessment of the sovereign’s institutional set-up, which we regard as a key rating driver, we consider the ESG factors ‘Judicial System and Property Rights’, ‘Quality of Public Services and Policies’, ‘Civil Liberties and Political Participation’, and ‘Integrity of Public Officials’ as highly significant to the credit rating.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating’s considerations on macroeconomic performance of the sovereign, and we regard the ESG factor ‘Labor’ as significant to the credit rating or adjustments thereof.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2016	2017	2018	2019	2020	2021	2022e
Macroeconomic Performance							
Real GDP growth	2.0	3.5	2.8	2.7	-8.4	4.9	6.3
GDP per capita (PPP, USD)	31,604	33,086	34,898	36,466	33,754	36,844	40,805
Credit to the private sector/GDP	124.9	115.1	109.0	101.8	112.0	108.1	n/a
Unemployment rate	11.5	9.2	7.2	6.7	7.0	6.6	n/a
Real unit labor costs (index 2015=100)	99.1	99.6	101.2	102.2	109.6	110.0	n/a
World Competitiveness Ranking (rank)	39	39	33	39	37	36	42
Life expectancy at birth (years)	81.3	81.6	81.5	81.9	81.1	81.2	n/a
Institutional Structure							
WGI Rule of Law (score)	1.1	1.1	1.1	1.1	1.2	n/a	n/a
WGI Control of Corruption (score)	0.9	0.9	0.8	0.8	0.8	n/a	n/a
WGI Voice and Accountability (score)	1.2	1.2	1.2	1.2	1.3	n/a	n/a
WGI Government Effectiveness (score)	1.2	1.3	1.2	1.2	1.0	n/a	n/a
HICP inflation rate, y-o-y change	0.6	1.6	1.2	0.3	-0.1	0.9	7.0
GHG emissions (tons of CO2 equivalent p.c.)	6.7	7.3	6.9	6.6	5.7	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-1.9	-3.0	-0.3	0.1	-5.8	-2.8	-2.1
General government gross debt/GDP	131.5	126.1	121.5	116.6	135.2	127.4	116.2
Interest/revenue	9.7	8.9	7.8	6.9	6.7	5.4	n/a
Debt/revenue	306.5	297.4	283.2	273.9	310.8	281.2	n/a
Total residual maturity of debt securities (years)	6.6	6.2	6.2	6.3	6.4	6.9	n/a
Foreign exposure							
Current account balance/GDP	1.2	1.3	0.6	0.4	-1.1	-1.1	n/a
International reserves/imports	0.4	0.3	0.3	0.3	0.4	0.3	n/a
NIIP/GDP	-110.5	-110.4	-106.4	-100.0	-104.8	-95.9	n/a
External debt/GDP	206.9	201.1	195.6	191.6	205.0	193.3	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, INE, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	28.10.2016	BB /stable
Monitoring	27.10.2017	BB+ /stable
Monitoring	21.09.2018	BBB- /positive
Monitoring	23.09.2019	BBB /positive
Monitoring	03.04.2020	BBB /stable
Monitoring	18.09.2020	BBB /stable
Monitoring	10.09.2021	BBB /stable
Monitoring	09.09.2022	BBB /positive

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The IGCP participated in the credit rating process as it provided additional information. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's ["Sovereign Ratings" methodology](#) (v1.2, July 2016) in conjunction with its basic document ["Rating Criteria and Definitions"](#) (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG's rating methodologies and basic document "Rating Criteria and Definitions" is published on our [website](#).

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, IMD Business School, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, UNCTAD, Fiscal Council, Agência de Gestão da Tesouraria e da Dívida Pública (IGCP), Banco de Portugal, Direção-geral da administração e do emprego público (DGAEP), and Instituto Nacional de Estatística, Direção-Geral do Orçamento (DGO), UTAM.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the

CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as “initial rating”; other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “affirmed”, “selective default” or “default”.

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: <https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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