EthiFinance Ratings

REPUBLICA DE PORTUGAL

PT | SOVEREIGN

ISSUER RATING
Long term

OUTLOOK
Positive

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Rating Action

EthiFinance Ratings affirms the Republic of Portugal's unsolicited rating at BBB+, but changes the outlook from Stable to Positive.

Rationale

The unsolicited rating of the Republic of Portugal (hereafter Portugal) reflects the dynamism shown by its economy in recent years, which has translated into significant improvements in the labor market, leading to a notable fall in unemployment levels. Although the rate of progress has slowed, we expect economic growth to remain above the country's long-term potential rate (considered to be 2%) over the medium term. Additionally, the rating factors in the correction of external imbalances and improvements in the stability of the financial system, plus the strong fiscal position, marked by budget surpluses, leading to a sharp downward trend in public debt. However, high debt levels remain one of the primary constraints on the rating. Furthermore, other risk factors persist, including social challenges (such as an aging population) and governance issues, with a fragmented political landscape following the 2024 elections, which could hinder the implementation of structural reforms. Despite these challenges, Portugal's outlook is set as Positive, with strong economic fundamentals and fiscal prudence supporting the potential for a rating upgrade in the next 12 months.

Executive Summary

Portugal's rating benefits from the diversified structure of its economy and the dynamism shown in recent years, although it is constrained by the size of the economy. After two years of strong economic growth following the Covid-19 downturn, the Portuguese economy slowed in 2023, with a growth rate of 2.3%. This slowdown is attributed to the cumulative effects of high inflation, tighter financing conditions, and weakness in the economies of main trading partners. These negative factors will also carry over to 2024, although to a lesser extent than previously estimated, in addition the economy will benefit from more moderate inflation and the good performance of tourism, hence we include in our macroeconomic scenario the Banco de Portugal's upward revision, with growth of 2.0% for 2024 and 2.3% in 2025 (1.2% and 2.2% previously).

Portugal's social situation represents one of the main constraints for the sovereign rating due to the aging population, with high dependency ratios and low population growth, along with low levels of GDP per capita compared to the European Union (EU) (see Figure 3). Portugal currently has a dependency rate of 58.4%, which is further compounded by sluggish population growth (0.1% in 2023), presenting a challenge to future growth potential and public finances. Nonetheless, we highlight the resilience observed in the labor market, with a sustained underlying reduction in the unemployment rate from 16.4% in 2013 to 6.5% in 2023. Additionally, although there was a slight increase in unemployment in 2023 (6.1% in 2022), it is expected to remain stable in the coming years around 6.5% (Banco de Portugal), while the employment rate continues to increase (expecting to reach 58% in 2024 compared to 57.8% in 2023 and 57.1% in 2022).

Portugal has also over recent years improved its external imbalances – which represented one of the country's main areas of vulnerability - although they remain elevated. Current account surpluses in recent years have allowed it to reduce debt. Additionally, although the country experienced current account deficits due to the effects of the pandemic - especially reduced tourism income - and the increase in energy prices, these have reversed (1.6% of GDP in 2023) and are expected to be stable in the coming years (1.1% in 2024 and 0.8% according to the European Commission). Therefore, along with the trend of deleveraging in both the public and private sectors, and the growth of nominal GDP, external imbalances have been reduced (but also remain high), with a net international investment position (NIIP) of -76% of GDP in 2023 (-106% in 2019) and external debt of 150% of GDP (196% in 2020). Furthermore, the country benefits from inclusion in the euro zone, considering the importance and stability of its currency.

Inflation has been declining, from a peak of 8.1% yoy in 2022, reflecting base effects, energy price normalization, and certain government measures such as the exemption of VAT on food items. The overall rate closed 2023 lower than initially expected (4.4% compared to the initially estimated 5.3%), and now stands at 2.2% (April 2024), with some early-year volatility due to the cessation of certain measures and base effects. We anticipate inflation to stabilize throughout the year, nearing the European Central Bank (ECB) target at 2.2%, and reaching it by 2025 (Banco de Portugal's estimates). However, there are risks, not least potential external pressures such as an escalation of conflict in the Middle East, which could raise once again transportation costs and energy prices.

Principio del formulario

The decline in inflation has also been assisted by the tightening of financing conditions. In mid-2022, the ECB announced the start of a period of tightening monetary policy, which continued until September 2023 when the marginal lending facility rate was raised to 4.5%. ECB rates have been unchanged since then and, due to the economic

cooling in the euro zone and lower inflation, we expect a first rates cut in mid-2024 and further easing in the second half of the year. Nonetheless, Portugal has carried out a remarkable restructuring of its financial system in recent years, mitigating the risks of higher interest rates for its banking system. The NPL ratio has decreased significantly, from 17.2% in 2015 to 2.7% in 2023. Likewise, liquidity levels are adequate (loan-to-deposit ratio at 78% in 2023), and banks' profitability has been lifted by higher interest rates (ROA of 1.3% in 2023 versus 0.7% in 2022).

On the public finances front, we highlight the rapid correction after pandemic-related strains, with a budget surplus already in 2023 (0.8% of GDP). Portuguese public finances have benefited from the gradual phasing out of pandemic-related public subsidies and rising revenues driven by inflation and economic growth. For this year and next, a surplus is expected to be maintained, albeit at lower levels (0.2% for 2024 and 2025 according to the IMF), due to the moderation in the pace of revenue growth coupled with lower inflation and economic activity, as well as the implementation of new spending measures. This improvement in the balance has been reflected in other indicators such as gross financial needs (1.9% of GDP in 2024 versus 13.9% in 2019).

In addition, the fiscal surplus is facilitating debt reduction, both in terms of the debt-to-GDP ratio – also driven by nominal GDP growth - and in absolute terms. Portuguese debt fell below 100% of GDP in 2023 (98.7%), a downward trend that we expect to continue in the medium term (see Figure 4). In spite of this decline, it remains one of the main constraints in our credit rating assessment, as it is still at an elevated level. Moreover, despite high interest rates, debt costs remained contained at 4.8% of current revenues in 2023, supported by the increase in the average debt maturity to 7 years in recent years.

Our methodology incorporates ESG (Environmental, Social, and Governance) principles into the rating process, and on this front we have observed improvement in recent years. Regarding the Environmental aspect, it is constrained by Portugal’s high energy dependence, which, although it had been declining, was exacerbated in 2022 by the definitive closure of coal plants and tensions in energy markets due to sanctions on Russia. However, we highlight the increase in renewable energy consumption in recent years, reaching 34.6% of total consumption in 2022, a trend expected to continue, especially considering the country's investments in this area, which will enhance its energy independence in the future. As for the Social aspect, there has also been improvement in wealth and well-being levels in recent years. The country is converging towards European GDP per capita levels, although it remains below the average (68% in 2023). This trend is also reflected in well-being levels, with an increase in the happiness index to 6 points from 5 points a decade ago, although the country still ranks 55th globally.

Regarding Governance, we have corrected the impact of the deterioration in corruption highlighted in our previous review in November 2023, due to the positive resolution of the corruption scandal in the Portuguese government's upper echelons, leading to the resignation of Prime Minister António Costa. This demonstrates the country's commitment to fighting corruption and the accountability of its leaders. However, the 2024 elections led to increased parliamentary fragmentation, resulting in a minority government. The current center-right government of the Democratic Alliance party led by Luís Montenegro holds 80 seats out of 230. While EthiFinance Ratings expects the current government to maintain fiscal prudence, there is increased uncertainty regarding decision-making, which could impact the rating if it hinders the implementation of structural measures, especially those required for receiving EU funds.

Main Figures

	2020	2021	2022	2023	2024E	2025E
Real GDP (% change)	-8.4%	6.2%	6.9%	2.3%	2.0%	2.3%
GDP per capita (current, €)	19,952	20,987	23,530	25,656	26,721	27,788
CPI (annual change, %)	-0.1%	0.9%	8.1%	4.4%	2.2%	2.0%
Unemployment rate (% labor force)	6.9%	6.6%	6.1%	6.5%	6.5%	6.4%
Dependence ratio (<19 and >65 y/20-64 y)	55.6%	55.9%	57.4%	58.4%	-	-
NPLs	4.9%	3.7%	3.0%	2.7%	-	-
ROA (financial sector)	0.0%	0.4%	0.7%	1.3%	-	-
Current Account Balance (% GDP)	0.4%	-1.0%	-0.8%	1.6%	1.1%	0.8%
NIIP (% GDP)	-104.8%	-95.9%	-87.6%	-76.0%	-	-
Fiscal Balance (% GDP)	-5.7%	-2.8%	-0.4%	0.8%	0.2%	0.2%
Public Debt (% GDP)	135.2%	125.4%	112.0%	98.7%	94.6%	90.7%
World Governance Indicators *	84.0	82.4	79.3	-	-	-

* Average of the 6 main World Bank World Governance Indicators: rule of law, regulatory quality, voice & accounting, government effectiveness, level of corruption, and political stability.

Fundamentals

Strengths

- Economic dynamism despite the European macroeconomic environment, expected to persist in the coming years, reflecting the economy's resilience against challenges such as the pandemic or price escalation.
- Presence of fiscal surplus in 2023 and the expectation of its continuation, which will contribute to reducing the public debt-to-GDP ratio.
- Maintenance of a declining unemployment trend and gradual convergence in terms of GDP per capita with its European counterparts.
- Remarkable financial cleanup resulting in a significant reduction in the non-performing loan ratio, enhancing the financial system's resilience to more restrictive financing conditions and changes in the economic environment.

Weaknesses

- High stock of public debt, although on a pronounced downward trend stemming not only from cyclical factors but also from fiscal consolidation efforts.
- Elevated volume of external debt and dependence on external financial flows, representing a vulnerability factor in the event of future exogenous shocks, albeit showing an improving trend.
- Presence of high dependency rates exacerbated by population aging, posing a future risk to public finances.
- Increase in parliamentary fragmentation following the 2024 elections, leading to a minority government currently in power, which hampers decision implementation and political predictability.

Outlook

The outlook change from Stable to Positive is based on the expectation of an improvement in the credit rating over the next 12 months. We expect the fundamentals of the rating to remain favorable, supported by the strong performance of the economy. Although GDP growth may decelerate, it is expected to stay above the long-term potential growth rate (put at 2%). This is coupled with fiscal consolidation efforts, maintaining fiscal surpluses and a trend of debt reduction, with the high debt levels being one of the main constraints on the rating. However, the change to a minority government introduces some uncertainty to the outlook regarding future policy implementation, although the current government is committed to maintaining fiscal prudence.Principio del formulario

Sensitivity Analysis

Detailed below are the factors that individually or collectively would impact Portugal's rating:

Positive factors (↑).

The credit rating and/or outlook could be upgraded if sustained economic growth above potential (2.0%) is achieved in the medium term, facilitating further convergence of per capita GDP towards the EU average. Additionally, maintaining surpluses in the current account, further addressing external imbalances, would have a positive effect. Moreover, greater fiscal consolidation could also enhance the rating, steering public debt towards levels more in line with the Maastricht Treaty benchmark (60% of GDP).

Negative factors (↓).

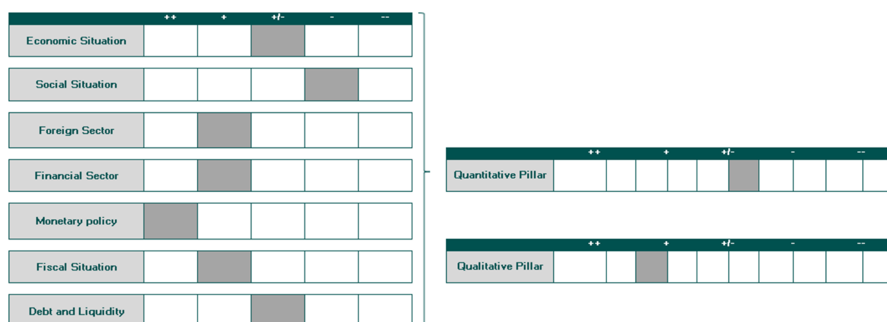
The credit rating and/or outlook could be downgraded if inflationary pressures persist and financing conditions tighten, potentially weighing on the economy and reversing the favorable trend observed in the financial system, leading to a non-performing loan ratio exceeding 10%. Furthermore, a reversal of the observed fiscal consolidation, with deficits surpassing 3% of GDP and debt rising above 100%, could trigger a downgrade. Additionally, a deterioration in governance due to increased parliamentary fragmentation, hindering the implementation of structural measures and political predictability, would also pose a risk.

Rating Committee

The rating committee agreed to maintain the rating with a revised outlook from stable to positive. The main topics discussed by the committee were the economic performance and forecasts for 2024 and 2025, the situation of the external sector, the situation of public finances and the evolution of public debt. The rating committee also discussed the country's current political situation.

Annexes

Scorecard



Main Figures: International Comparison

	Year	Portugal	Spain	France	Italy	Germany
Real GDP (% change)	2024E	2.0%	1.9%	0.7%	0.7%	0.2%
GDP per capita (current, €)	2023	25,656	30,236	41,000	34,864	48,632
CPI (interannual change, %)	2024E	2.2%	2.6%	2.4%	1.6%	2.4%
Unemployment rate (% labour force)	2023	6.5%	11.6%	7.4%	7.8%	3.3%
Dependency rate (% 20-64 yo population)	2023	58.4%	50.9%	62.5%	57.4%	56.9%
NPL	2021	3.0%	3.8%	1.8%	2.9%	0.9%
ROA	2021	0.4%	0.5%	0.3%	0.4%	0.3%
Current Account Balance (% GDP)	2024E	1.1%	1.1%	6.5%	-1.3%	0.9%
NIIP (% GDP)	2023	-76.0%	-55.6%	-29.1%	5.7%	68.5%
Fiscal Balance (% GDP)	2024E	0.2%	-3.1%	-4.9%	-4.6%	-1.5%
Gross Public Debt (% GDP)	2024E	94.6%	106.3%	111.6%	139.2%	63.7%
World Governance Indicators	2022	79.3	73.2	80.2	67.3	88.4

Figures

FIGURE 1. SOCIOECONOMIC RISK PROFILE. RANGE 0 (BEST) TO 10 (WORST)

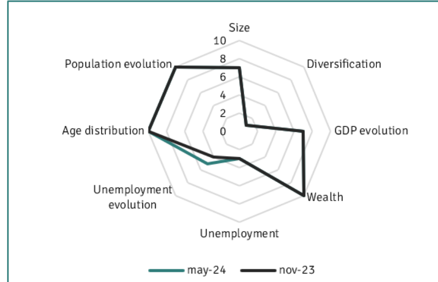


FIGURE 2. FISCAL RISK PROFILE. RANGE 0 (BEST) TO 10 (WORST)

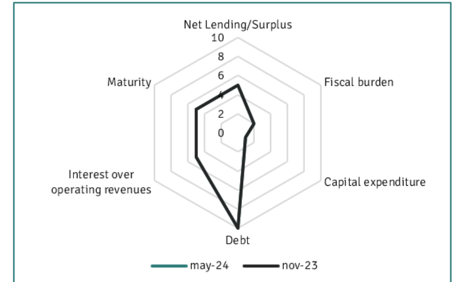
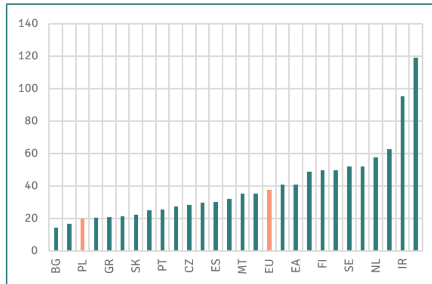
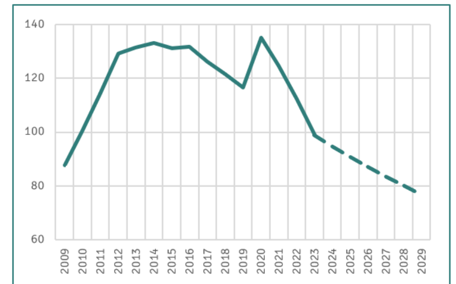


FIGURE 3. GDP PER CAPITA COMPARISON, 2023 (THOUSAND CURRENT EUR)



SOURCE: EUROSTAT

FIGURE 4. PUBLIC DEBT EVOLUTION (2009-2029E, % OF GDP)



SOURCE: IMF

Sources of information

The credit rating issued in this report is unsolicited. The main sources of information used are the following:

1. Public information from public access sources, mainly official statistics institutes, central banks, and other government sources, in addition to the OECD, Eurostat, World Bank, European Central Bank and International Monetary Fund, among others.
2. Own information of EthiFinance Ratings.

The information was thoroughly reviewed to ensure that it is valid and consistent, and is considered satisfactory. Nevertheless, EthiFinance Ratings assumes no responsibility for the accuracy of the information and the conclusions drawn from it.

Level of the rated entity participation in the rating process

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

Additional information

- The rating was carried out in accordance with Regulation (EC) N°1060/2009 of the European Parliament and the Council of 16 September 2009, on credit rating agencies. Principal methodology used in this research are :
    - Sovereign Rating Methodology : https://files.qivalio.net/documents/methodologies/CRA 157 V1.Sovereign Rating Methodology.pdf
- The rating scale used in this report is available at https://www.ethifinance.com/en/ratings/ratingScale.
- EthiFinance Ratings publishes data on the historical default rates of the rating categories, which are located in the central statistics repository CEREP, of the European Securities and Markets Authority (ESMA).
- In accordance with Article 6 (2), in conjunction with Annex I, section B (4) of the Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009, it is reported that during the last 12 months EthiFinance Ratings has not provided ancillary services to the rated entity or its related third parties.
- The issued credit rating has been notified to the rated entity, and has not been modified since.

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