ISSUER RATING

Long-term Rating

Outlook: Negative

First rating date: 18/01/2019
Review date: 03/07/2020

Analysts

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Content

Executive Summary

We affirm the credit rating of the Republic of Portugal of BBB+ with a change of outlook from stable to negative based on the expected significant impact of the COVID-19 on the Portuguese economy. In this sense, and although it is true that the country has been one of the least affected countries in Europe by number of contagion and deaths, our credit rating takes into account the foreseeable depth of this shock over its economy given its high dependence on the services sector, highlighting tourism, and the increasing importance of its international trade. In this regard, recent information reported that the Portuguese economy contracted in the first quarter of 2020 by 3.8% and the forecasts for 2020 point to an unprecedented fall in GDP that could exceed 9.4% in a year-on-year basis, with a weak upturn in 2021 at a rate of 6.3% year-on-year, and with a deterioration of both the labour market -the unemployment rate could reach 11.6% this year-, and the fiscal balance, putting an upward pressure on its high level of public debt.

Our credit rating points out the good starting point of the Portuguese economy relative to this economic shock, with a GDP that in 2019 grew again above its main European counterparts, the continuous improvement of the labour market that has led it to reach minimum levels of unemployment, and the remarkable process of fiscal consolidation that has allowed it not only to maintain a primary surplus, but also a fiscal surplus that contrasts sharply with the deficit presented on average by the Eurozone. However, the rating is constrained by the high level of public debt, both in absolute and relative terms, of which we expect a rapid deterioration, although we take into account the progressive improvement in the debt sustainability not only because of the consolidation path observed in public finances and the early repayment of part of the rescue funds, but also because of the low interest environment and the good levels of liquidity favoured by the expansive monetary policy implemented by the ECB.

Fundamentals

Strengths

- Positive evolution of the economy during 2019 with growth rates that exceeded the Eurozone average.
- The progressive process of fiscal consolidation has resulted in a surplus of 0.2% - which has even exceeded the forecasts made by the Ministry of Finance - and the maintenance of a primary surplus.
- Improved labour market conditions where productivity has increased in most sectors and growth of wages has been higher than in previous years.
- Health measures were adopted in the early stages of the pandemic and cooperation between the different political parties have led to a calm and constructive political environment, including the approval of supplementary budgets as a starting point for promoting economic recovery.

Weaknesses

- Despite the favourable evolution of the public debt levels, Portugal remains as one of the most indebted nations, a situation that will worsen this year considering the expected deterioration of the public finances and the economic recession.
- The possibilities of a second wave of infections could aggravate the final impact of this economic shock, slowing down the process of economic recovery given its high dependence on international trade and tourist activities.
- The economic shock will slow down the process of convergence in terms of GDP per capita with its European partners.
- Public finances are expected to deteriorate, not only because of the fall in revenue, but also because of the increase in expenditure, but with a forecast deficit that will be lower than that of its European counterpart.

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Summary of figures

	2017	2018	2019	2020F
Real GDP (% change)	3,5%	2,4%	2,2%	-9,4%
Real GDP per inhabitant (%UE28)	65,1%	65,9%	66,5%	-
HCPI	1,5%	1,2%	0,3%	0,2%
Unemployment rate (% labour force)	8,9%	7,1%	6,5%	11,6%
People- at -risk (%)	23,3%	21,6%	-	-
Non-Financial Corp. Debt (% GDP)	163%	156%	-	-
Balanza corriente (% PIB)	1,2%	0,4%	0,0%	-0,6%
NIIP (% GDP)	-110%	-106%	-100,8%	-
NPL	13,3%	9,4%	6,1%	
Loan-to-deposits	92%	89%	87,3%	-
General Balance (%GDP)				
Primary Balance(% GDP)	0,9%	3,0%	3,2%	-3,1%
Public Debt (%GDP)	123,9%	120,1%	117,6%	135,9%

Sources: INE, Bank of Portugal, Eurostat, European Commission, IMF & Axesor

Outlook

Our BBB+ rating with a change in trend from Stable to Negative is based on uncertainties derived from the COVID-19, and although it is true that the initial situation of its public finances showed an improvement in relation to those prevailing in previous crises, the impact that this pandemic will end up having on the economy will reverse the recovery process in which the Portuguese economy was immersed, above all due to its important tertiary sector and dependence on tourism, which could end up impacting its public finances, putting upward pressure on its high level of public debt.

Sensitivity analysis

Although we consider it unlikely, the credit rating of the Republic of Portugal could be upgraded if GDP deterioration was significantly lower than expected, economic recovery in 2021 evolved at a much higher pace and if public finances resumed its path of fiscal consolidation and debt reduction. On the other hand, the rating could worsen if the impact on the economy is greater than expected, public debt grows at a faster pace and public finances show a further and prolonged deterioration.

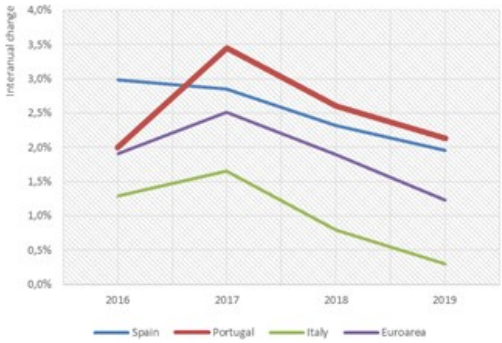
Rating Commitee

The commitee has agreed to maintain the credit rating with a change of Outlook. The main points discussed have been the economic forecasts for 2020 and 2021 and the effects of this shock over the fiscal balance and public debt.

1. Socio-economic situation

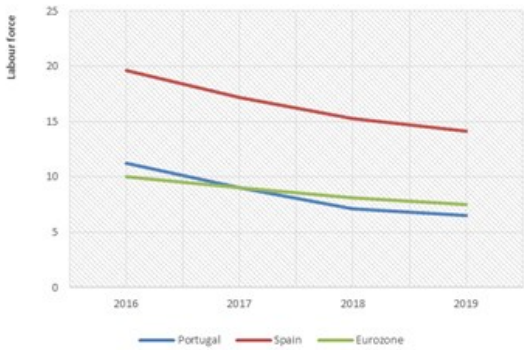
Our credit rating of BBB+ / Negative underlines the positive evolution observed in the Portuguese economy over the last few years, with a year-on-year growth rate of 2.2% which practically doubled the 1.2% presented by the Eurozone during the same period of time, a situation which had a positive effect on the labour market, which grew generating employment although at a lower rate than in previous years due to the progressive slowdown in growth that was being observed in the Portuguese economy.

Figure1: GDP evolution. Internacional comparative.



Source: European Commission & Axesor Rating

Figure 2: Unemployment rate evolution. International comparative.



Source: European Commission & Axesor Rating

Axesor Rating highlights the better starting point presented by the Portuguese economy at the beginning of the economic shock triggered by the COVID-19 crisis, with an economy that for a third year in a row continued to lead the growth ranking of the Eurozone, largely explained by the good performance of both domestic demand and the foreign sector. This trajectory in the past years, has favoured convergence in terms of GDP per inhabitant, which, however, continued to be below 65% of the EU average, one of the negative elements of our rating.

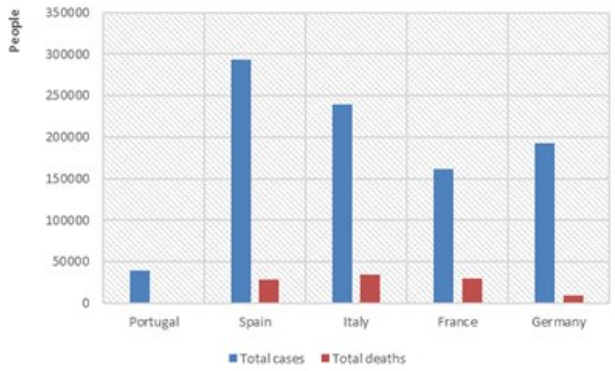
Furthermore, we would like to highlight the favourable evolution observed in the Portuguese **labour market**, with a significant improvement in productivity -which grew at a much higher rate than in its main European partners- in most sectors of activity, being the performance observed in the services sector particularly remarkable.

We cannot forget the continuous correction of the unemployment rate due to the dynamism observed in the labour market, with a reduction from 6.7% registered at the end of 2019 to 6.5% observed at the end of the first quarter of 2020. However, our credit rating takes into account the persistent problem of duality and quality of work, with employment closely linked to the service sector with the lowest added value, with Portugal being the second country in the Euro Zone with the highest number of temporary contracts and unemployment especially affecting the youngest age groups, a situation that poses a challenge on the face of the economic shock caused by Covid19.

1.1. Economic shock triggered by COVID-19

Despite the solid performance observed, Portugal has not been spared from the effects of the health crisis triggered by the COVID-19, and although the number of people infected and reported deaths is far from those observed in other European countries (Italy, France and Spain), Portugal was one of the first countries to declare the State of Alarm (March 13, 2020), a situation that was progressively extended until its end on May 2, one of the first economies in the Euro Zone to do so, but, on the other hand, the last economy to open its borders.

Figure 3: Infected and deceased by COVID-19. Comparative.



Sources: John Hopkins & Axesor Rating.

To date, Portugal has recorded nearly 40,000 infections and 1,540 deaths. In recent months, Portugal has been an example in the fight against COVID-19, thanks to the quick action and approval of measures to deal with the pandemic. Despite this good performance in terms of the number of infections and deaths, the severity of the measures implemented by the Portuguese Government has been comparable to that of the other more affected countries, as shown by the Stringency Index published by the University of Oxford.

In this regard, and in order to flatten the infection curve in the absence of effective antiviral and preventive treatments, most countries adopted measures which cause a halt in the economic activity and force citizens to be confined.

In the case of Portugal, whose economy is based on tertiary activity and highly dependent on tourism (8% of GVA and 9% of employment), this paralysation of the activity led to an unprecedented contraction in GDP in the first quarter, of almost -3.8% quarter-to-quarter, which was far from the -5.2% observed in Italy, France and Spain.

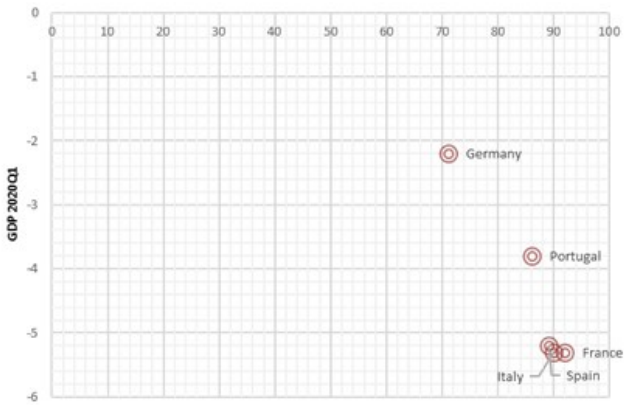
In fact, forecasts indicate that Portugal will be one of the European economies most affected by this situation, with a contraction in GDP that is expected to reach 9.4% year-on-year - under the assumption that there will be no upturn of infections in autumn - followed by a recovery during the following year with an estimated growth rate of 6.3%. The uncertainty surrounding this situation should not be forgotten, as these forecasts could change depending on various factors, such as future outbreaks in the coming months.

Despite the fact that full confinement measures only affected the second half of March, on the demand side there has been a fall in household income and the larger consumption decisions have been delayed as well as the level of consumer confidence. In fact, the economic agents most affected are the self-employed and SMEs, about 16% of shops have closed temporarily during the month of March. In addition, vehicle registration fell by 57% and production by 46% in the same period. That is why it is expected that private consumption will fall this year by 10% year-on-year.

To face this situation, and to avoid a greater depth of this shock, the Government has taken several fiscal measures simultaneously and complementary to the monetary policy measures approved by the European Central Bank (in a low HCPI scenario), focused on three pillars: health, social and business

These include: 600 million euros allocated to the fight against job losses (0.3% GDP), moratoriums on social security payments worth 7.9 billion euros (3.7% GDP), 13 billion euros allocated to guarantee credit lines for SMEs to ensure business liquidity (6.8% GDP) as well as monthly contributions to the health system worth 400 million euros (0.2% GDP).

Figure 4: Stringency Index



Source: University of Oxford.

With regard to monetary policy we highlight the increase in the volume of the ECB's Pandemic Emergency Purchase Program and the future European Reconstruction Fund (that will include grants and loans for European countries) for its role in the control of risk premiums and the liquidity environment, improving the sustainability of Portugal's large public debt.

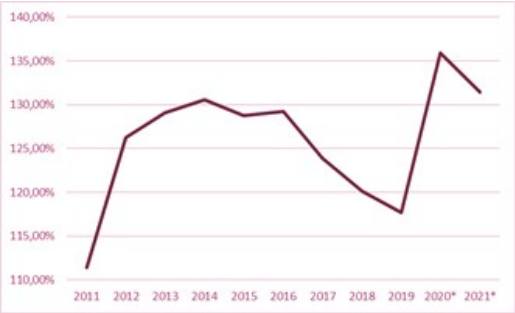
Despite these stimulus packages, we note that inflation has been kept under control and is not expected to exceed 0.2% in 2020, far from the ECB's mandate, which in turn will allow the stimulus packages to be maintained at least for the coming year.

Finally, our credit rating of BBB+ / Negative considers the notable improvement observed in the Portuguese financial system, positioning it in a more favourable position to face the current crisis. Its average ROA has increased to 0.7% and the NPL ratio has been reduced from 9.4% to 6.1%, improving the quality of its balance sheets, although this metric continues to be one of the highest in the Eurozone, a situation that will foreseeably worsen in the short term as a result of the significant deterioration of the economy already mentioned. Nevertheless, Portuguese banks are starting off with better levels of capitalization that will allow them to assume the foreseeable deterioration in their loan portfolios.

2. Fiscal balance, debt and liquidity

Our credit rating reflects the positive evolution of public finances, materialized in a significant consolidation process, highlighting the first fiscal surplus of 0.2% of GDP since the beginning of the economic recovery, almost 0.6 percentage points above the deficit registered in 2018 and exceeding the initial forecasts of the Ministry of Finance of 0.1%.

Figure 5:Evolution of de Gross Debt/ GDP ratio



Source: OECD

*Forecasts

Figure 6: Fiscal balance evolution. International comparision

Source: OECD

*Forecasts

In fact, in 2019 Portugal reached a primary surplus of 3.2%, in line with the trend observed in previous years, remaining above the figures presented by its main European peers, favouring the process of debt reduction observed during the last years.

Public finances reflected a growth in current revenues of 3.9%, and a reduction of interest expenses to levels of 7.5% of current revenues thanks to the low interest environment favoured by the expansive monetary policy of the ECB.

On 17 December, before the pandemic, the 2020 budget was approved, contemplating important structural reforms. On the revenue side, we highlight tax reductions, both in the tax on individuals and in commercial companies; and on the expenditure side we highlight the increase in personnel expenditures and the increase in social transfers.

However, and due to the impact of the COVID-19, the Parliament has approved an Additional Budget to face the consequences of this economic shock. Expenditures will increase by approximately EUR 4.3 billion more than pre-Covid projections.

In fact, we expect an important deterioration of the fiscal balance (to -7.9% of GDP) as a consequence of the decrease in revenues due to the reduction of the production and import tax collections. In this sense, a fall in revenues of 6.2% year-on-year is expected for 2020. For 2021 the economic recovery will allow an increase in revenues of 6.4% year-on-year.

We estimate that this deterioration in public finances will put upward pressure on the already high levels of public debt, one of the main constraints on our rating and the primary reason for the change of outlook.

Although it is true that the public debt-to-GDP ratio shows a favourable evolution, with a noticeable reduction to 117.6% of GDP, from the 120.3% recorded in 2018, we expect a new increase in debt to almost 135.9% in 2020 due to the current economic shock, a situation that would tend to improve, slightly, in 2021 when debt is expected to fall back to 131.4%, placing the Portuguese economy in a more vulnerable position to economic shocks than its European peers.

Nevertheless, Axesor Rating underlines its continuous reduction, both in absolute and relative terms, being remarkable the full payment of its obligations to the IMF in 2018, and the advance payment of 2 billion Euros to the European Financial Stability Fund, all in line with the requirements and forecasts of the Stability and Growth Pact. All in all, the actions undertaken have led to an improvement in the debt repayment profile.

However, and although its sustainability is at adequate levels thanks to the liquidity and low interest environment favoured by ECB, it is worth noting the significant concentration of maturities scheduled for 2020 and 2021, of 14 billion and 24 billion euros respectively, the latter figure also including 6 billion euros corresponding to the pseudo-assistance it received from the Economic and Financial Assistance Programme.

These figures will be added to the increased need for debt issuance to finance the deficit generated in these two years, although we do not expect tensions in the markets in view of the debt purchase programme - recently extended - by the ECB and the European Reconstruction Fund pending approval.

3. Institutional framework and governmental situation

Our credit rating considers the appropriate institutional framework that shapes the functioning of the Portuguese Government, as well as its transparency measures and instruments of supervision and control. We believe that its formation guarantees the correct evolution of labour relations. As shown by Portugal's governance indicators, they are within the best ranges of each of them, highlighting the efficiency of government and the control of corruption and violence in the country.

We also value that Portugal is a member of the European Union, and its economy is favoured by the use of a single currency, economic cooperation between its members and it has access to aid in situations of imbalance that otherwise would have a deeper impact on the country, as occurred with the pseudo-assistance received in 2011 in the face of the sovereign debt crisis and which was meant to improve public finances, an objective that is being achieved in the short term and, predictably, in the long term, prior to Covid.

Despite the current minority government, our rating reflects the climate of understanding and coordination between the different political parties with the aim of initiating a new economic recovery, which is reflected in the recent approval of the Additional Budget for 2020.

4. Annexes

4.1. International Comparision

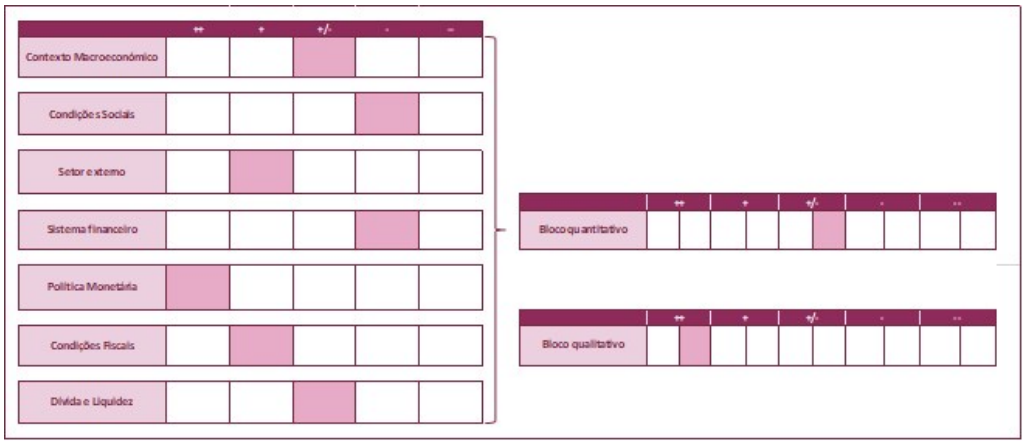
	Date	Spain	Germany	France	Italy	Portugal
Macroeconomic						
GDP (B$)	2019	1,923	4,443	3,061	2,454	346
Real GDP (% change)	2019	2.0%	0.6%	1.3%	0.3%	2.2%
GDP per capita	2019	26.440	41.350	35.960	29.610	20.660
Current Account Balance (% GDP)	2019	1.99%	7.14%	-0.758%	2.97%	-0..08%
NIIP (% GDP)	2019	-74%	71.2%	-23.3%	-1.7%	-100.8%
HICP	2019	0.8%	1.4%	1.3%	0.6%	0.3%
Unemployment rate	2019	14,1%	3,15%	8,4%	9,9%	6,5%
Population (thousands inhabitants)	2019	46,937	83,019	67,012	60,359	10,276
People-at-risk (% population)	2018	26.1%	18.7%	17.4%	27.3%	21.6%
Global Competitiveness Index (rank)	2019	23	7	15	30	34
Happiness Index (Rank)	2019	28	17	23	30	59
Non-Financial Corp. Debt (% GDP)	2018	132.7%	100.3%	195.4%	112.7%	167.4%
Financial System (1)						
NPL	2019	3.2%	1.3%	2.5%	6.7%	6.1%
LTD	2019	1.11	1.31	1.15	1.08	0.87
ROA	2019	0.5%	0.0%	0.4%	0.4%	0.4%
Public Sector						
Surplus / Deficit (% GDP)	2019	-2.8%	1.4%	-3.0%	-1.6%	0.2%
Primary Surplus / Deficit (% GDP)	2019	-0.5%	2.3%	-1.6%	1.7%	3.4%
Structural Surplus / Deficit (%GDP)*	2019	-2.9%	0.7%	-2.3%	-1.9%	-0.1%
Gross Public Debt (% GDP)	2019	95.5%	59.7%	98.1%	134.8%	117.7%
Gross Financing Needs (% GDP)*	2019	16.8%	10.3%	16.9%	22.1%	13.9%
Governance indicators (rank)						
Voice and responsability	2018	82	95	88	81	88
Political Stability	2018	55	66	51	57	89
Governement Effectiveness	2018	79	93	91	68	86
Regulatory Quality	2018	80	94	83	73	78
Rule of Law	2018	80	91	89	61	85
Control of Corruption	2018	72	95	87	62	80

1) EBA. Harmonised

*Forecasts

Sources: INE, Eurostat, IMF, World Bank, European Commission, ODCE & ECB.

4.2. Scorecard



Regulatory information

Sources of information

The credit rating issued in this report is unsolicited. The credit rating is based exclusively on public information, being the main sources 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 Axesor Rating.

The information was thoroughly reviewed to ensure that it is valid and consistent, and is considered satisfactory. Nevertheless, Axesor Rating 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, and in accordance with the Sovereign Rating Methodology and Outlook Methodology that can be consulted on www.axesor-rating.com/en/about-axesor/methodology and according to the Long-term Sovereign Rating scale available at www.axesor-rating.com/en/about-axesor/rating-scale.
- Axesor 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 axesor 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.

C/ Graham Bell. Edificio Axesor s/n de Armilla (Granada)

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