BBB+

ISSUER RATING

Long-term Rating

Tendencia: Estable

Fecha de primer rating: 18/01/2019
Fecha de revisión: 17/11/2023

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Content

Rating Action and Rationale

Ethifinance Ratings confirms the Republic of Portugal's unsolicited credit rating at BBB+ with a Stable outlook.

The unsolicited rating on the Republic of Portugal (hereafter Portugal) responds to the rapid recovery observed during 2021 and 2022, which has been sustained in 2023, albeit at a more moderate pace. Our rating also takes into account the positive effect that the NGEU Funds will have on potential growth in the medium term, while the size of its economy is small and still far from converging to European Union (EU) GDP per capita levels. In addition, we highlight the consolidation of the financial system carried out in recent years. As for public finances, although we note a rapid correction of some imbalances in the public accounts, and the decreasing trajectory of the public debt ratio, the latter remains at high levels, representing one of the main limitations of its credit rating.

Nevertheless, at Ethifinance Ratings we underline the persistence of downside risks to economic performance that could end up having an impact on the rating: first, the maintenance of inflation at levels far from the European Central Bank's (ECB) mandate, leading to a further tightening of financing conditions; and second, the deterioration of governance evidenced by recent corruption cases at prominent levels of the executive branch, including the resignation of the prime minister and the call for early elections, posing a significant increase in uncertainty. This scenario could lead to further parliamentary fragmentation, complicating the adoption of structural measures within the framework of the NGEU Funds and affecting the predictability of the fiscal path.

Executive Summary

The Portuguese economy consolidated its post-COVID-19 recovery in 2022, growing by +6.9% year-on-year, thus reaching pre-pandemic GDP levels. Although the country experienced a robust start of the year, driven by the carry-over effect from the previous year, domestic demand and tourism, this momentum slowed down during the second and third quarters (see Figure 3). This slowdown is attributed to the cumulative effects of inflation, tighter financing conditions and weakness in the economies of its main trading partners. As a result, our macroeconomic scenario envisages a slowdown in growth, although still above potential, estimated at +2.3% and +1.5% by the International Monetary Fund (IMF), for 2023 and 2024 respectively (compared to estimates of +2.7% and +1.8% in our previous review of May 2023).

In addition, the social situation in the country remains stable, although a slight upturn in unemployment rates is expected, while structural problems persist. In this regard, we expect the slowdown in economic activity to translate into the labor market, where we assume a rebound in unemployment to 6.6% of the labor force in 2023 (6.1% in 2022), albeit still below the 7% recorded in 2019. Nevertheless, the social situation is constrained by the high population aging and low levels of GDP per capita. Thus, Portugal has a dependency ratio of 54.7%, which is increasing in the face of low population growth, posing a challenge for future growth potential and public finances. Furthermore, although GDP per capita shows an upward trend, it is still significantly below the EU average (23,287 euros compared to 70,423 euros in 2022).

In the external sector, we see an improvement driven by the solid performance of tourism, the normalization of energy prices and the slowdown in imports due to weak domestic demand. Accordingly, we anticipate a higher current account surplus than initially expected, with the IMF estimating a 1.3% of GDP in 2023 and 1.1% in 2024 (1% and 0.8% previously expected). This improvement is also reflected in the net international investment position (NIIP), which has maintained a downward trend in recent years. In this sense, the Portuguese NIIP has moved from -104.8% of GDP in 2020 to -87.6% in 2022. A trend that we expect to continue in the coming years - in the first half of 2023 it stood at -78.6% - also favored by grants from the European Recovery and Resilience Mechanism and nominal GDP growth. However, the high dependence on external financial flows continues to represent a limiting factor for the credit rating and a potential risk due to the considerable stock of external debt (173.9% of GDP at the end of the third quarter of 2022).

Inflation, meanwhile, has been on a downward trend since the peak observed in 2022 (+8.1% year-on-year), although it is expected to persist at a high level. Initially driven by higher energy and food prices, inflation eventually shifted to other goods and services. During this fiscal year, we have been observing a downward trend favored by the base effect, the normalization of energy and some government measures such as the VAT rebate on food. Notwithstanding, the latest developments in fuel prices, wage pressure and tourism services have kept inflation above what we initially expected, with the IMF estimating +5.3% in 2023 and +3.4% in 2024, not reaching levels in line with the ECB target until 2026.

The price adjustment will also be favored by the tightening of financing conditions. During the middle of last year, the ECB announced the start of the interest rate hike cycle, bringing it to 4.5% as of September 2023. Although the ECB has now slowed the hiking cycle due to the economic cooling in the euro zone, levels are expected to remain elevated at least through this and next year. However, Portugal has carried out a remarkable consolidation of its financial system in recent years, thus mitigating the risks of hikes on its banking system. In this regard, the NPL ratio has decreased significantly, from 17.2% in 2015 to 3.2% in 2022, a position it has maintained during the first half of 2023 (3.1%).

In terms of public finances, we highlight the rapid correction after the imbalances resulting from the pandemic, with deficit levels below those established by the Maastricht Treaty and a public debt that shows a decreasing, although still high, evolution. With the gradual elimination of public aid from the pandemic and the increase in revenues driven by inflation and the economic evolution, Portugal closed 2022 with a deficit of -0.4% of GDP. For the current year, favorable revenue factors are expected to be maintained and expenses controlled, with the European Commission estimating in its autumn forecast a surplus of 0.8%, a situation that is expected to extend, albeit to a lesser extent, to 2024, with a forecast of 0.1%. Nevertheless, we highlight the return to primary surplus levels in 2022 and the estimates for 2023, favoring a reduction in the volume of debt. Thus, the Portuguese public debt maintains a marked downward trend, although still at high levels -108.3% of GDP in 2023 and 104.0% in 2024 according to the IMF-, representing one of the main limitations of our credit rating.

Our methodology incorporates ESG (Environmental, Social and Governance) principles in the rating process, in which we have observed an improvement in recent years in Portugal. However, Portugal is still below the European average in most social aspects and maintains a high energy dependence (66.9% of energy consumed was imported in 2021). We also highlight the role of the Recovery and Resilience Plan, which is expected to allow the country to continue improving in this area, due to its environmental and social nature, in addition to increasing its potential growth.

Regarding governance, it has deteriorated due to the corruption scandals that led to the resignation of Prime Minister Antonio Costa and the convocation by President Marcelo Rebelo de Sousa of early elections for March 2024, originally scheduled for 2026. In our previous reports we highlighted the increase in political stability with the results of the last elections where Antonio Costa had achieved an absolute majority, which guaranteed the approval of budgets and other structural reforms. Notwithstanding, the current scenario raises the possibility of a fragmented parliament and high uncertainty in decision making, which could again affect the governance of the country.

Fundamentals

Strengths

- The economic recovery observed during 2021 and 2022, recovering pre-pandemic GDP levels, which is expected to be sustained in the coming years, reflecting the resilience of the economy in the face of challenges such as the pandemic or soaring prices.
- The primary surplus given in 2022 and expected for 2023, which will contribute to the reduction path of the public debt ratio.
- The maintenance of a decreasing path of unemployment and the gradual convergence in terms of GDP per capita with its European partners.
- Significant financial restructuring resulting in a reduction in the non-performing loan ratio, which has improved the financial system's resilience in the face of tighter financing conditions and changes in the economic environment.

Weaknesses

- High stock of public debt, although it presents a marked downward trend derived not only from cyclical factors, but also as a result of fiscal consolidation.
- High volume of external debt and dependence on external financial flows, representing a factor of vulnerability to future exogenous shocks.
- Presence of high dependency rates aggravated by the aging of the population, which poses a future risk to public finances.
- Slowdown in the economic growth of the main European partners as a result of the restrictive monetary policy and the weak performance of the manufacturing sector.
- Increased political uncertainty and deterioration of governance, evidenced by corruption scandals and the resignation of the prime minister. In addition, the call for elections in 2024 could result in a fragmented parliament, affecting decision making and political stability.

Main financial figures

	2020	2021	2022	2023E	2024E
Real GDP (% change)	-8.4%	6.2%	6.9%	2.3%	1.5%
GDP per inhabitant (current, €)	19,658	20,840	23,287	25,209	26,222
CPI (annual change, %)	-0.1%	0.9%	8.1%	5.3%	3.4%
Unemployment rate (%labor force)	6.9%	6.6%	6.1%	6.6%	6.5%
People-at-risk (%population)	20.0%	22.4%	20.1%	-	-
Population (thousands)	10,287	10,345	10,311	10,321	10,331
Dependence ratio	55.6%	55.9%	57.4%	-	-
NPLs	4.9%	3.7%	3.2%	-	-
ROA (financial sector)	0.0%	0.4%	0.7%	-	-
Current Account Balance (%GDP)	-1.1%	-1.2%	-1.2%	1.3%	1.1%
NIIP (%GDP)	-104.8%	-95.90%	-87.6%	-	-
Fiscal Balance (%GDP)	-5.7%	-2.8%	-0.4%	0.8%	0.1%
Public Debt (%GDP)	135.2%	125.4%	116.0%	108.3%	104.0%

Outlook

The maintenance of the Stable outlook is based on the continuity of the macroeconomic situation and its public finances despite the current international situation. Thus, we expect the country to maintain growth levels above its potential, supported by a labor market that continues to be resilient. It will also be favored by a healthy financial system and a decreasing trend in inflation. In addition, we highlight the country's significant fiscal consolidation following the pandemic, correcting debt levels, which until now have been one of the main factors limiting our credit rating. However, early elections in 2024 following the resignation of Antonio Costa introduce a potential risk element. The possibility of greater parliamentary fragmentation could complicate the predictability of the country's fiscal path, representing an aspect that will be closely monitored in upcoming reviews.

Sensitivity Analysis

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

Positive factors (↑).

The credit rating and/or the outlook could improve if economic growth remains higher than expected in the medium term, favoring the convergence of GDP per capita levels towards those of the EU. In addition, further fiscal consolidation could also have a positive effect on the rating, bringing public debt towards more sustainable levels.

Negative factors (↓).

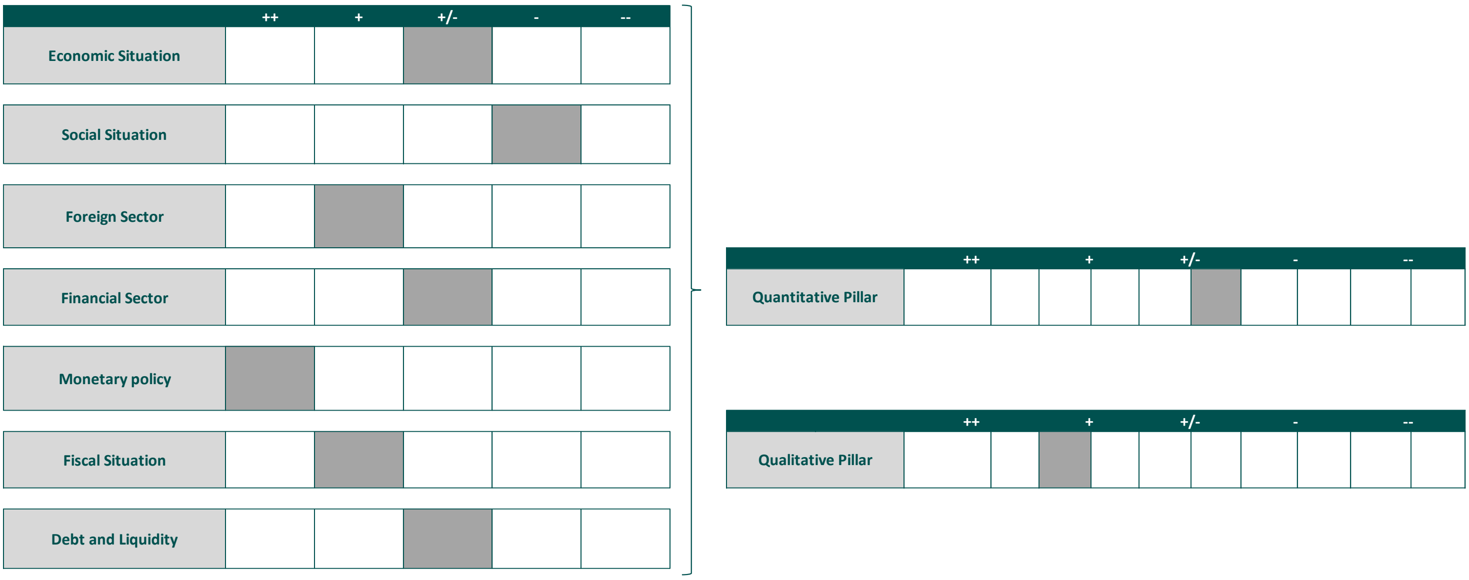
The credit rating and/or outlook could worsen if inflationary pressures and tighter financing conditions persist, which could weigh on the economy and reverse the favorable developments observed in the financial system; and/or a setback in the observed fiscal consolidation, with increases in deficit and debt levels; and/or a further deterioration of governance through new corruption cases or greater parliamentary fragmentation after the 2024 elections, reducing confidence in institutions and hampering the adoption of structural measures and the predictability of the fiscal path.

Rating Committee

The rating committee has agreed to affirm the rating of the Republic of Portugal with stable outlook. The main topics discussed during the committee have been: macroeconomic forecasts, fiscal outlook and the budget for 2024, and the current political situation, among others.

Annexes

1.1 Scorecard



1.2 Figures

Table 1. Macroeconomic chart, Portugal (2Q2022-3Q2023, var. y-o-y, %)

	2Q2022	3Q2022	4Q2022	1Q2023	2Q2023	3Q2023
Gross domestic product	7.4	4.8	3.4	2.5	2.6	1.9
Household final consumption expenditure	4.7	4.4	2.8	1.5	1.4	-
Final consumption expenditure by government	1.0	-0.3	1.4	0.2	1.1	-
Gross fixed capital formation	3.9	1.7	1.0	-4.5	-0.6	-
Domestic demand	3.9	3.1	2.2	0.1	1.0	-
Exports	25.2	16.3	7.6	10.1	4.3	-
Imports	15.2	11.7	5.4	4.5	1.3	-

Source: National Institute of Statistics of Portugal

Figure 1. Socioeconomic risk profile. Range 0 (best) to 10 (worst)

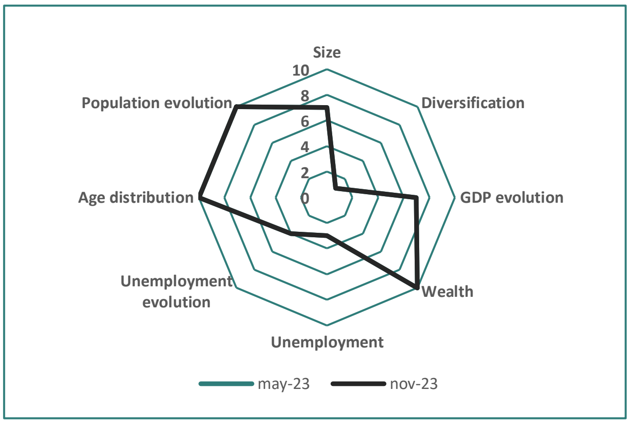


Figure 2. Fiscal risk profile. Range 0 (best) to 10 (worst)

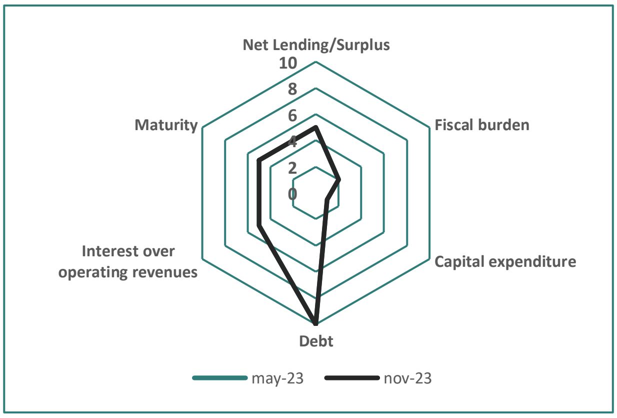
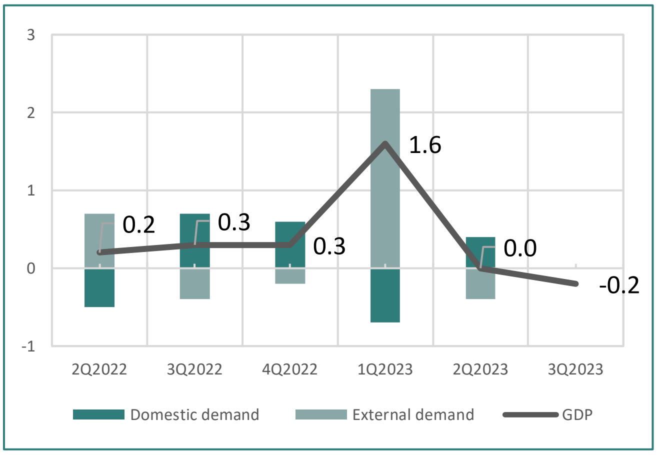


Figure 3. Quarterly GDP growth (quarter-on-quarter, % change)



Source: National Institute of Statistics of Portugal

1.3 Main Figures. International Comparison

	Year	Spain (A-/Stb.)	Portugal (BBB+/Stb.)	Germany	France	Italy
Real GDP (% change)	2022	5.8%	6.9%	1.8%	2.5%	3.7%
GDP per capita (current, €)	2022	27,871	23,290	46,149	38,585	32,390
HCPI (interannual change, %)	2022	8.3%	8.1%	8.7%	5.9%	8.7%
Unemployment rate (%labor force)	2023E	12.7%	6.6%	3.2%	7.4%	7.8%
Population (million inhabitant)	2022	47.6	10.3	83.7	68.0	58.9
People-at-risk (%population)	2022	26.0%	20.1%	20.9%	21.0%	24.4%
Dependency rate (% 20-64 yo population)	2022	51.6%	57.4%	56.5%	62.5%	57.5%
NPL	2022	3.8%	3.2%	1.1%	1.8%	2.8%
ROA	2022	0.5%	0.7%	0.3%	0.2%	0.6%
Current Account Balance (%GDP)	2023E	1.6%	1.0%	5.9%	-0.5%	0.0%
NIIP (%GDP)	2022	-63.8%	-87.6%	73.7%	-24.1%	5.3%
Fiscal Balance (%GDP)	2023E	-4.1%	-0.1%	-2.3%	-4.7%	-4.5%
Gross Public Debt (%GDP)	2022	118.4%	116.0%	66.5%	111.0%	144.6%
Net Public Debt (%GDP)	2022	102.9%	109.5%	45.0%	99.0%	132.9%
Gross Financing Needs (%GDP)	2023	13.6%	7.6%	11.6%	16.0%	23.0%

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