Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF PORTUGAL	Assigned Ratings/Outlook: **BBB /positive**	Type: Monitoring, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	28-10-2016 23-09-2019 “Sovereign Ratings” “Rating Criteria and Definitions”

Rating Action

Neuss, 23 September 2019

Creditreform Rating has raised its unsolicited long-term sovereign rating on the Republic of Portugal to “BBB” from “BBB-”. Creditreform Rating has also raised Portugal`s unsolicited ratings for foreign and local currency senior unsecured long-term debt to “BBB” from “BBB-”. The outlook remains positive.

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Key Rating Drivers

1. Solid GDP growth should remain in place in 2019/20, mainly buttressed by rebounding investment and healthy household spending, while dragged down by increasing external headwinds; medium-term growth prospects are held back by high NFC debt, curbing investment, and subdued productivity growth
2. Sovereign is characterized by a strong institutional setup; expectation of broad policy continuity including sustained commitment to prudent public finances with a view to the October 2019 general elections
3. Benefiting from robust economic activity, expenditure containment, and falling interest expenses, fiscal consolidation is making headway; in the absence of significant discretionary policy changes in the aftermath of the elections, budget should be broadly balanced in 2020
4. Although government debt is set to remain on a firm downward trajectory, it should remain high over the years to come, representing the sovereign’s main credit weaknesses; improving but still comparatively weak asset quality in the banking sector continues to carry contingent liability risks
5. Elevated but gradually subsiding external vulnerabilities; risks related to a highly negative NIIP and high levels of net external debt somewhat tempered by shifts in the composition of the external debt stock and expectation of moderate current account deficits going forward

Reasons for the Rating Decision

Creditreform Rating has raised its ratings on the Portuguese Republic to “BBB” from “BBB-“. The upgrade is underpinned by (i) reinvigorated and robust economic activity, which evolved in line with our expectations and was supported by significantly improving labor market metrics; and (ii) headway in fiscal consolidation, which has resulted in a considerable reduction of the sovereign’s heavy debt burden.

The outlook on the Republic of Portugal remains positive, reflecting our expectation that (i) the Portuguese economy will continue to post solid economic growth over the next two years; (ii) the positive labor market momentum will be sustained; and (iii) the debt-to-GDP ratio will remain on a firm downward path driven by resilient economic growth and large and recurring primary surpluses.

Macroeconomic Performance

Regarding its macroeconomic performance, Portugal’s longer-term track record gives a mixed picture. In 2011-13, Portugal recorded negative growth rates due to cost competitiveness issues, deleveraging needs in the public and private sector, and an ailing banking system, before entering a recovery in the final quarter of 2013, which gradually strengthened thereafter. In 2017, the Portuguese economy enjoyed the strongest growth in seventeen years, with real GDP expanding by 2.8%. However, economic developments in 2018 suggest that the cyclical upswing has passed its peak, with real GDP growth softening to a still robust 2.1% (EA-19: 1.9%). As observed in most euro area countries, a deceleration in economic activity in the second half of the year hampered Portuguese growth in 2018. After displaying a yearly growth of 2.5% in Q2-18, quarterly GDP growth fell to 2.1% (Q3), before it dropped to 1.7% y-o-y in the final quarter of the year.

Slower growth came on the back of notably weaker net exports in 2018. After net exports had already detracted 0.2 p.p. from GDP growth in 2017 (Eurostat, base year 2010), the growth contribution from trade worsened to -0.6 p.p. last year, as robust import dynamics coincided with moderating external demand. A weaker macroeconomic backdrop in the euro area, intensifying trade tensions, and negative base effects took a toll on Portuguese exports. After hitting a seven-year high at 7.8% in 2017, partly mirroring new production facilities put into operation in the automotive industry and a strong tourism season, export growth decelerated to 3.7% in 2018. As revealed by INE data, growth in export of equipment and intermediary goods eased considerably, posting growth rates of 3.3 and 4.3% in nominal terms, down from 11.9 and 9.2% in 2017. In addition, inbound tourism, which accounts for more than half (51.5%) of total service exports, shifted into a lower gear. Export receipts from travel still grew by a robust 9.6%, but less vigorously than in the previous year (+19.5%).

Alongside slowing external demand, weaker investment dynamics restrained output growth in 2018. Following an extraordinarily strong performance in 2017, when gross fixed capital formation contributed 1.5 p.p. to growth, its contribution almost halved to 0.8 p.p. last year. Overall, investment growth moderated to a still healthy 4.5% in 2018, after skyrocketing by 9.2% in 2017. Neither construction nor machinery and equipment

investment were able to retain their 2017 growth rates. Partly due to slowing external demand and base effects from capacity expansions in the automotive industry in 2017, growth in machinery and equipment investment slowed from 13.5 (2017) to 6.4% in 2018. In the same vein, growth in construction investment weakened from 8.4 to 3.1% in 2017-18. Mirroring the completion of large-scale tourism-related construction projects, capital spending on other buildings and structures almost came to halt, posting an annual growth rate of 1.4% (2017: +9.4%). Meanwhile, dwellings investment held up relatively well, increasing by 6.1% y-o-y (2017: +6.4%), thanks to the sustained recovery in housing prices.

Private consumption was the main growth driver in 2018, contributing 1.7 p.p. to economic expansion. Edging up to 2.6% (2017: 2.3%), last year witnessed the strongest growth in private household spending in fourteen years (2004: 2.6%). Above all, private consumption benefited from further improving labor market metrics, as employment and wages recorded positive growth last year. Supported by accelerating nominal wages and subdued HICP inflation, which eased from 1.6 (2017) to 1.2% (2018), real wage growth turned the corner. According to AMECO data, real compensation per employee rose by 0.6% in 2018, having contracted in 2014/15 and broadly stagnating in 2016/17.

Looking ahead, we expect the Portuguese economy to further lose steam, anticipating GDP growth of 1.8 and 1.6% in 2019 and 2020 respectively. Our expectation is underpinned by latest quarterly national accounts data, indicating that growth stabilized at 1.8% in both Q1- and Q2-19 (Q4-18: 1.7%). Though remaining the main driver of the economic expansion, we assume domestic demand to grow at a slower pace than in recent years, as rebounding investment should only partly compensate for gradually cooling private consumption. Net external trade, on the other hand, should continue to drag on growth over the coming two years given our expectation of brisk import growth, in particular.

Available trade statistics up to Q2-19 show that the maturing economy cycle in Portugal's key trading partners is increasingly weighing on export dynamics. External demand from Portugal's most important export markets - Germany, France and Spain - continued to dwindle in the first half of the year, increasing by a modest 2.8% y-o-y (H1-18: +8.6%). Adding to this, we observed a further slowdown in tourism receipts. Between January and June, exports of travel services expanded by 6.5% y-o-y (H1-18: +13.9%).

Notwithstanding elevated uncertainties surrounding the outlook for exports in 2019/20, we are cautiously optimistic on investment. Gross fixed capital formation was off to a strong start to the year, displaying quarterly growth rates of 11.8 and 6.9% in the first half of the year. Public investment should be supported by the implementation of some large-scale infrastructure projects, partly financed with ESI funds. Drawing on EU Cohesion data, disbursements paid out under the current 2014-20 programming period inched up from 34% of total EU allocations (EUR 8.91bn) at the end of 2018 to 43% (EUR 11.13bn) to September 2019. Turning to the private sector, latest data on industry confidence and capacity utilization signals a sustained expansion in machinery and equipment investment. Capacity utilization in the Portuguese industry sector remains high and has increased somewhat since the beginning of 2019. In Q3-19, it stood at 80.1%, up from 79.4

and 77.8% in the first and second quarter respectively. Also, industry sentiment has proven to be relatively resilient from a longer-term perspective so far. What is more, recent monetary policy decisions should have a positive impact on corporates' refinancing conditions and in turn, their propensity to invest. The average annualized agreed rate on new NFC loans posted at a 2.3% in June 2019, close to its historical low (Dec-17: 2.1%). Looking ahead, we expect the current interest rate environment to remain in place up to 2021 at least. In view of softer euro area growth prospects and intensifying uncertainties surrounding Brexit and global trade, the ECB governing council decided to ease its monetary policy stance more recently. At its latest meeting on 12 September, the governing council decided to lower the interest rate for the deposit facility by 10 basis points to -0.5% and to resume net purchases under the APP in a monthly amount of EUR 20bn as from 1 November.

Alongside investment, private consumption should continue to spur economic growth in 2019/20. High frequency indicators such as consumer confidence and retail sales point to robust consumer spending in the remainder of 2019. While retail sales (except motor vehicles) grew by 4.7% in July (June: +4.2%), the European Commission's Consumer Sentiment Index appears to have bottomed out, improving for the second consecutive month. In general, household spending should be supported by further rising disposable incomes. Adding to the minimum wage hike, which entered into effect at the beginning of the year, the unfreezing of careers in the public sector, tax reductions, and easing inflationary pressures, should bolster consumers' purchasing power. Partially due to discretionary cuts in administered prices for electricity and public transport, we anticipate HICP inflation to decrease to 0.8% this year. Going into 2020, we expect growth in consumer spending to remain solid but ease somewhat against the backdrop of the prospective slowdown in employment growth. What is more, the low level of household savings should limit the expansion of private consumption further out. In the year to Q1-19, the savings rate of Portuguese households fell slightly from a low 4.6 to 4.5% (1999-2018 average: 8.1%).

Our expectation that favorable labor market developments will continue in 2019/20 was a key driver of our decision to maintain a positive outlook on the sovereign's ratings. Aided by active labor market policies and cyclical economic tailwinds, almost half a million jobs have been created since 2013, while unemployment (2013: 16.3%) has since more than halved. Last year, the unemployment rate fell to 7.0%, down from 9.0% in 2017 – the lowest level since 2002 (6.2%). Decreasing unemployment was accompanied by the fifth consecutive year of job creation. Favorable labor market dynamics carried over into 2019, with the unemployment rate continuing on its downward trajectory in the first half of the year. In Q2-19, unemployment posted at 6.6%, comparing favorably with 7.6% in the euro area. Job creation also continued, though its pace has slowed notably from 3.1% at the beginning of 2018 to 1.9% in Q4-18 and 0.8% in Q2-19.

To be sure, the Portuguese labor market is still facing structural challenges. Standing at 21.0% in Q2-19, the share of employees (15-64y) with temporary contracts is only higher in Spain (26.0%) in the EA-19. In particular, younger workers are affected by labor market segmentation. According to Eurostat data, two out of three employees (62.4%) at age

15-24 have fixed-term working contracts. Also, youth and long-term unemployment remain elevated, although continuing on a firm downward trajectory. While youth unemployment (15-24y) has decreased by 22 p.p. since Q1-13, it still posted at a high 19.4% in the second quarter of 2019.

Gradually intensifying skills shortages, coupled with the minimum wage hike in January, continue to exert upward pressure on wages. Monthly growth in total gross earnings per employee accelerated in the first half of 2019, averaging at 3.6% y-o-y, as compared with 1.9% in the first six months of 2018 (INE data). Thus, it appears likely that wage dynamics will continue to outpace labor productivity this year, resulting in moderately rising real unit labor costs as seen in 2017/18. Notwithstanding the resumption of positive ULC growth, we see limited risks to the economy's competitive position in the near term. In 2018, real unit labor costs stood still 7.7% below 2010 levels, comparing favorably with developments in Portugal's main trading partners (ES: -6.3%; FR: +0.9%; DE: +2.0%) and the euro area as a whole (-1.5%). Accordingly, Portugal has gained in terms of global export market shares. Last year, its export market share in goods (0.35%) and services (0.66%) was higher than in 2010 (0.33%; 0.60%).

In the medium term, however, keeping unit labor costs in check appears important given the Portuguese economy's relatively high exposure to sectors we consider as price-sensitive. Trade, transport and accommodation, which includes the important tourism sector, contributed a quarter (24.8%) to gross value added (GVA) in Q4-18 alone. On the other hand, the industrial sector and high value-added services still play a minor role. At the latest count, ICT and professional services accounted for only 3.6 and 7.9% of GVA respectively, both among the lowest shares in the EU-28. Diversifying the economy towards industries with a higher value added would not only enhance economic resilience, but also help to boost per capita incomes. As highlighted by IMF data, Portugal exhibited a GDP per capita of USD 32,006 (PPP terms) in 2018. While this compares rather high by global standards, we note that Portugal features one of the lowest GDP per capita levels in the euro area. More importantly, the income gap towards the EU-28 has widened since the early 2000's – long before the economic crisis hit. Down from 84.4% in 2000, Portuguese GDP per capita dropped to 74.2% of the EU-28 level in 2018. Still, it has to be mentioned that its per capita income as a percentage of the weighted EU-28 average has stabilized more recently.

In general, we expect the Portuguese economy to experience solid growth beyond 2020, as the job rich economic recovery has contributed to an increase in the economy's potential growth rate in recent years. Having risen from 0.4 to 1.6% between 2015 and 2018, the EU Commission estimates that Portugal's potential growth is now broadly on par with the euro area. In view of an ageing population, however, tailwinds from rising employment are likely to abate gradually. Hence, growth is likely to become more reliant on productivity gains and capital accumulation, which have been less supportive in the recent past.

Nominal labor productivity per person thus remains low, reaching only 73.7% of the EU-28 average in 2018, partly explained by comparatively low educational attainment levels. Despite a decrease from 69.2 (2009) to 49.8% (2018) over the last decade, the population

share with less than lower secondary education (ISCED2) remains the largest in the EU-28 (27.6%).

Meanwhile, investment in both the public and the private sector has not recovered to its pre-crisis level yet. As evidenced by the latest increase from 1.8 (2017) to 2.0% of GDP in 2018, public investment appears to have bottomed out; but was still at the lowest level observed in the EU-28. Turning to the private sector, capital accumulation has outpaced GDP growth in the years beyond 2013, but at 15.1% of GDP (2018), investment activity remains significantly below the annual average in 2000-07 (20.3% of GDP). In our view, a stronger rebound in investment is impeded by several factors. Most importantly, the corporate sector's capacity to invest is still constrained by ongoing deleveraging efforts. Although NFC's debt has significantly fallen from its peak at 122.8% (Q4-2012) to 90.4% of GDP in Q1-19, debt levels remain substantially higher than in most euro area countries. Moreover, structural bottlenecks continue to hamper investment. Portugal's business environment was found to be generally favorable by the World Bank's 2018 Doing Business report (rank 34/190), but dealing with construction permits, the protection of minority investors, and access to finance were identified as major weakness. Also, taxation remains an issue. Currently, Portugal's combined corporate income tax rate of 31.5% is the second highest in the OECD, and dealing with taxes is more time-consuming than in comparable high-income economies.

Admittedly, the Portuguese authorities are gradually implementing measures to address issues related to productivity and investment. To boost capital spending, the government presented the "National Investment Program 2030" in January 2019, which envisages the spending of EUR 21.95bn on various projects in the areas of transport, energy and environmental sustainability, with the sector of transport and mobility receiving the largest share of the funds (EUR 12.68bn). In order to incentivize higher business investment, Portuguese authorities adopted measures to streamline the tax system. While Decree Law no. 81/2018, adopted in October 2018, contained a set of measures intended to reduce the length of proceedings in administrative and tax courts, the implementation of the "Simplex 2019" program aims to shorten the time needed to deal with taxes by merging social security and tax declarations into a single monthly declaration. Moreover, we note that efforts are underway to lift skill levels of the Portuguese workforce in order to raise labor productivity. Ongoing reforms pertaining to the vocational and higher education system are complemented by measures to foster the adult population's skills.

Institutional Structure

Portugal's credit rating continues to mirror the high quality of its institutional framework. First and foremost, with regard to the World Bank's latest edition of the Worldwide Governance Indicators (WGIs), Portugal's rankings are broadly on par with the euro area median across all dimensions, and significantly better than those of other former program countries such as Cyprus and Greece. It is also noteworthy that the sovereign's performance regarding the quality of policy formulation and implementation, as well as citizens' participation rights, appears to have strengthened over the last few years. Since 2014, Portugal has climbed from 44 (government effectiveness) and rank 36 (voice and ac-

countability) to rank 27 and 24 respectively (euro area median rank: 33 and 27). Thus, Portugal now receives higher scores on these indicators than most of our A-rated sovereigns.

In general, we believe that the institutional framework and the economy have benefitted from a relatively high degree of political stability in recent years. Since 2015, the country has had a Socialist-led minority government headed by PM Costa (PS), which has proven remarkably stable. Relying on the support of far-left parties such as Left Bloc and the Portuguese Communist Party, the government adopted moderate legislative changes in the area of social benefits and labor markets in order to strengthen social cohesion. Overall, however, we observed no major policy setbacks and reform reversals after the country's conclusion of the economic adjustment program in 2014, and authorities remained committed to fiscal discipline.

Recent events have corroborated our view that the current administration continues to put great emphasis on prudent budgetary polices. In May 2019, the more conservative parties in parliament (Christian Democrats and Social Democrats) joined forces with the far-left to approve retroactive pay hikes for teachers that had been held back over nine years. PM Costa strongly opposed this plan, arguing that retroactive payments for one sector would prompt a flood of demands by other civil servants, undermining the government's efforts to balance the budget. Eventually, parliament rejected the proposal to avoid Costa's resignation. Latest polls indicate that the Socialists can expect to emerge as the strongest party again from the October general elections. Given that PM Costa has ruled out a formal coalition with the hard left if his party fails to win a parliamentary majority, the current minority government is likely to remain in place. Against this background, we assume policy continuity, including a sustained commitment to stability-oriented macroeconomic and budgetary policies.

Portugal draws significant benefits from its EU membership, entailing access to structural and cohesion funds, being the largest non-CEE recipient of ESI funds on a per capita basis. With regard to the country's EMU membership, we believe that advantages associated with the common currency, namely broad and deep capital markets and the euro's reserve currency status are broadly balanced by the loss of monetary flexibility. We note that price and especially wage developments have been not well synchronized with the euro area as a whole.

Fiscal Sustainability

The sovereign's credit ratings continue to be constrained by very high though declining general government debt and legacy issues in the domestic banking sector, which continue to represent elevated contingent liability risks for public finances.

After the headline deficit had temporarily increased from 2.0% (2016) to 3.0% in 2017 due extraordinary financial support to the banking sector (see below), it sharply narrowed in 2018. Last year's deficit on the general government level came in at 0.5% of GDP, corresponding to the lowest level in 45 years and slightly outperforming authorities' deficit target foreseen in the 2018 stability program (0.7% of GDP). Most importantly, last year's

budgetary outcome was buoyed by positive base effects. Following the state's recapitalization of Caixa Geral de Depósitos (CGD) in 2017, which had a deficit increasing impact of EUR 3.944bn or 2.0% of GDP, capital transfers to the banking sector were much lower last year. Via the bank resolution fund, the general government injected EUR 792m (0.4% of GDP) into Novo Banco in 2018. Moreover, lower debt service costs had a dampening effect on expenditure dynamics. Interest expenses fell from 3.8 to 3.5% of GDP in 2017-18, thereby contributing 0.3 p.p. to fiscal improvement.

In general, the Portuguese government remained committed to expenditure containment. The overall increase in government outlays (net off capital transfers and interest expenses) of 3.7% was broadly aligned with nominal GDP growth in 2018 (3.6%). This was in particular a result of authorities' under-execution on public investment as well as moderately growing spending on social benefits (+3.1%) and employee compensation (+2.2%). In addition, favorable developments on the revenue side were supportive to budget consolidation. Reflecting robust economic activity, strong job growth and a record-high number of foreign visitors, revenue intake surprised on the upside, with the revenue-to-GDP ratio climbing from 42.7 to 43.5% in 2017-18 (SP18: 42.2% of GDP). Growth in net social security contributions maintained its 2017 momentum and increased by 4.9% (2017: 4.9%), concurrently taxes on income and wealth (including PIT- and CIT-receipts) expanded by 6.4%, marking the strongest growth rate since 2013.

We expect fiscal consolidation to continue but slow down this year in view of softening GDP growth and a somewhat less restrictive fiscal stance. Apart from a further capital injection worth EUR 1.15bn or 0.6% of GDP under the contingency capital mechanism to Novo Banco, the government decided to ease access criteria to the early retirement regime and to continue with the unfreezing of public sector careers. The latter will imply additional expenditures of about EUR 540m in 2019, as per Ministry of Finance estimates. What is more, the number of civil servants continued to increase by 2.3% y-o-y in the first half of 2019 (DGAEP data), which together with higher spending on healthcare should put some pressure on government accounts in 2019. However, the deficit-increasing impact of these policy measures should be more than offset by further declining interest expenses, projected savings from a spending review, and sustained revenue growth. In this context, we note that the 2019 budget introduced only minor changes pertaining to the revenue side. The minimum and maximum income tax rates remained unchanged; the same applies to the two new PIT brackets that were introduced in 2018. In January, tax incentives to attract Portuguese citizens living abroad entered into effect, offering a 50% reduction in employment and self-employment income tax for five years, including the first year of arrival. The eventual revenue loss stemming from of this tax rebate strongly depends on the number of returning citizens, but we currently believe that it will have a negligible effect on the budgetary outcome in 2019. Summing up, fiscal developments in the first half of the year support our view that the government may achieve its deficit target of 0.2% of GDP this year. Between January and July 2019, the government ran a cash-deficit of EUR 445m equivalent to 0.2% of GDP.

Looking ahead into 2020, we note that the October general elections imply some uncertainty to the budgetary outlook. If the current minority government were to be replaced

by another formal or informal political alliance, we consider it likely that the 2020 draft budget will be eventually augmented by additional fiscal measures later on. Contingent on the assumption that no significant spending decisions will be adopted after the 2019 general election, we anticipate a further improvement in Portugal's fiscal position and the budget to be broadly balanced next year.

A further improving budget balance complemented by a gradual reduction in the government's cash buffer as well as sustained GDP growth, should help to further lower the government's high debt burden. Portugal remains one of the most heavily-indebted EU members, with only Greece (181.1% of GDP) and Italy (132.2% of GDP) posting higher debt levels, although the government's debt stock has materially decreased since 2016. Over the last two years we observed a steep decline in public debt. According to Eurostat data, the debt-to-GDP ratio fell from 129.2% in 2016 via 124.8 (2017) to 121.5% of GDP in 2018.

Last year's decline in the government's debt stock was primarily driven by a very large primary surplus, with 3.0% of GDP one of the highest readings in the EU-28, which more than offset debt negative stock-flow adjustments. Furthermore, prudent debt management operations resulted in a decline of the implicit interest rate on state debt. Over 2018, Portuguese authorities not only continued buying back bonds maturing in the short-term, they also redeemed the last outstanding tranche of the EUR 26bn IMF loan far ahead of the original repayment schedule, which had foreseen the last repayment to the Fund coming in 2024. According to Portuguese authorities, the reimbursements, which started in March 2015, have saved the country a cumulative EUR 1.9bn in interest payments in 2015-18 (IGCP data).

As evidenced by recent events, Portugal remains committed to its debt management strategy, aiming to replace official loans with cheaper market funding. On 5 September, the EFSF Board of Directors approved Portugal's request to make an early repayment of EUR 2bn of EFSF loans. The reimbursement corresponds to a full repayment of a loan tranche maturing in August 2025 and partial repayment of a tranche maturing in December 2025. Early repayments are facilitated by favorable market conditions for Portuguese sovereign debt. Long-term bond yields have significantly declined since our last review, plummeting from 1.9% (Sep-18) to a record-low 0.06% on 15 August 2019, while the spread over German bunds narrowed by about 60 base points. We believe that decreasing risk premia can largely be attributed to the ECB's further postponement of monetary policy normalization and to prudent budget execution. Regarding the latter, we believe that a credible commitment to sustained fiscal consolidation is a prerequisite to preserve the current financing conditions. Sudden fiscal policy shifts may quickly erode investor confidence, which may result in sharply increasing borrowing costs – not only for the public sector.

As of now, it seems unlikely that sharply rising interest rates will jeopardize debt reduction in the near term. In our view, the materialization of contingent liabilities in the banking and SOE sectors currently represents the main downside risk to Portugal's public finances. At the latest count, the debt stock of Portuguese SOEs totaled a high 19.2% of GDP (Q2-19), with about 3.4% not included in the general government sector (INE). In

particular, the financial situation of public hospitals remains an issue. As in previous years, the government injected additional funds into the hospital sector to clear payment arrears. As a result, arrears declined from EUR 0.84bn to EUR 0.48bn in the year to December 2018. It remains to be seen whether the government's new hospital governance framework can prevent a renewed accumulation of overdue payments in the future.

Finally, crisis legacies in the banking sector could adversely impact the government budget and debt trajectory going forward. In the past few years CGD and Novo Banco have faced serious problems, resulting in costly state interventions. We acknowledge that these interventions together with other measures contributed positively to the capital position and thereby, to the resilience of major Portuguese banks. Nevertheless, further state interventions, particularly under Novo Banco's Contingent Capital Agreement, cannot be ruled out as asset quality and profitability remain relevant challenges to Portuguese banks.

To be sure, a gradual recovery in the domestic banking sector is underway, as indicated by sustained improvements across various financial soundness indicators. Regarding banks' funding profile, we observe further improvements, with the loan-deposit-ratio falling from 90.9 to 86.4% in the year to Q1-19 on the back of ongoing deposit inflows from the private sector. Though still the third highest reading in the EU-28, the NPL ratio of Portuguese banks notably decreased from 13.6% (Q1-18) to 9.6% in Q1-19 (EBA data), thanks to a recovery in the real estate market, write-offs, and asset disposals. Thus, the share of impaired assets has more than halved over the last three years (Q1-16: 19.8%). Meanwhile, the CET1 ratio of the banking sector increased only slightly from 13.1 (Q1-18) to 13.4% in the first quarter of 2019. Hence, capital buffers remain among the lowest in the euro area, with only Spanish and Italian banks displaying a lower CET1-ratio recently. The capital generation of Portuguese banks is still hampered by subdued profitability. Alongside ongoing loan loss provisioning, subdued credit demand continues to exert pressure on profitability metrics.

Despite the pick-up in new lending to both NFCs and household's, overall credit growth remains muted. As indicated by ECB data, the outstanding credit volume to the NFC sector has been in decline since mid-2011 and it continued to show negative y-o-y growth in July 2019 (-3.1%). Conversely, lending to households appears to be in the early stages of a recovery. After contracting for seven years, credit outstanding to households stabilized in 2018 before positive growth resumed. In June and July, credit to households posted growth in the 2% range, particularly driven by strongly expanding consumer lending (10% y-o-y), while mortgage lending was broadly flat. The latter development supports our view that vividly rising house prices do not present a financial stability risk at the moment. Since 2016, house price growth has steadily accelerated from 6.1 to 9.0% last year, partly reflecting strong tourism-induced demand for apartments in major metropolitan areas and government incentives (Visa program) for non-European investors.

Foreign Exposure

On the external side, we see elevated but gradually subsiding vulnerabilities. External imbalances continue to unwind slowly as the Portuguese economy carries on with delev-

eraging. Its net international investment position (NIIP) remains among the most negative in the EU-28, although having improved from -118.6 to -100.8% of GDP in 2014-18 thanks to a reduction in net external debt from 104.3 to 89.0% of GDP over the same period. We believe that the current composition of the external debt stock is leaving the Portuguese economy less prone to external financing risks than a few years ago. Since the end 2014, the proportion of government and MFI-related external debt has decreased, while the share which can be attributed to the central bank and FDI-inflows has increased from 9.1 and 18.4 to 12.4 and 26.2%, respectively. The rising share of debt held by the central bank mainly reflects large-scale sovereign bond purchases under the Public Sector Purchase Program (PSPP). Up to May 2019, cumulative net purchases of Portuguese government securities under the PSPP added up to EUR 39.0bn.

External rebalancing was facilitated by robust GDP growth and a turnaround in the current account balance. Having averaged at -8.9% of GDP between 2000 and 2012, the current account has been close to balance ever since. More recently, Portugal's current account deteriorated from 0.5 to -0.6% of GDP in 2017-18, as a widening trade in goods deficit was not entirely offset by an improving trade in services balance. Reflecting a briskly growing domestic economy boosting import demand, the goods deficit widened from 6.2 to 7.3% of GDP in 2018, while the country's already high trade in services surplus increased for the fourth consecutive year, having risen from 8.0 to 8.3% of GDP. Last year's 0.3 p.p. improvement in the services balance was completely driven by tourism, as net receipts from travel strengthened from 5.6 to 5.9% of GDP. In the near term, we expect the current account deficit to widen somewhat, due to robust investment activity boosting import growth, and moderating external demand.

Rating Outlook and Sensitivity

Our Rating outlook on Portugal's sovereign ratings is positive, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to improve over the next 12-24 months.

We could raise Portugal's credit ratings if we see economic growth in line with our current expectations, benign labor market conditions are sustained, and/or the public debt ratio continues on its downward trajectory. Further upward pressure could result from a reinvigorated structural reform momentum leading to a sustainable improvement of the economy's external competitiveness and its medium-term growth potential, or if financial soundness indicators approach EU-28 levels, which would in turn, reduce contingent liability risks.

While the positive outlook indicates that a downgrade is rather unlikely, downward pressure on the outlook or the rating could arise if medium-term growth prospects fall short of our baseline scenario, or if cost competitiveness were to deteriorate notably in the absence of counteracting policy measures, also signaled by sizeable current account deficits over an extended period of time. We could also revise our outlook or the rating in case of significant fiscal slippages, prompted by additional public support for ailing banks

or if, contrary to our current expectations, a newly formed government leaves the current fiscal consolidation path in the wake of the general elections in October 2019. More generally, substantial backtracking on reforms geared towards improving the economy's medium-term growth potential could also trigger a rating downgrade.

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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

Economic Data

	2013	2014	2015	2016	2017	2018	2019e
Real GDP growth	-1.1	0.9	1.8	1.9	2.8	2.1	1.8
GDP per capita (PPP, USD)	26,415	27,302	28,213	29,163	30,622	32,006	33,166
HICP inflation rate, y-o-y change	0.4	-0.2	0.5	0.6	1.6	1.2	0.8
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	80.9	81.3	81.3	81.3	81.6	n.a.	n.a.
Fiscal balance/GDP	-4.8	-7.2	-4.4	-2.0	-3.0	-0.5	-0.2
Current account balance/GDP	1.6	0.1	0.1	0.6	0.5	-0.6	n.a.
External debt/GDP	226.9	235.9	222.0	214.1	209.4	204.7	n.a.

Source: International Monetary Fund, Eurostat, 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

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.

This sovereign rating is an unsolicited credit rating. The Agência de Gestão da Tesouraria e da Dívida Pública (IGCP) participated in the credit rating process as IGCP provided additional information and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of IGCP during their review. However, the rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". 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 the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG has used 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, 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.

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".

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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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