Rating Object	Rating Information	
REPUBLIC OF PORTUGAL	Assigned Ratings/Outlook: **BBB /stable**	Type: Monitoring, Unsolicited with participation
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 10-09-2021 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating Action

Neuss, 10 September 2021

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "BBB" for the Republic of Portugal. Creditreform Rating has also affirmed Portugal's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "BBB". The outlook remains stable.

Key Rating Drivers

1. Solid growth record prior to the corona crisis, which should be resumed in 2021/22; Portuguese labor market and private sector balance sheets experienced a Covid-related setback and remain balancing factors for the otherwise favorable macro profile; however, multi-year improvement is likely to continue after the transitory shock
2. Virus mutations present downside risks to the recovery, particularly weighing on the tourism industry; NGEU-related funds should deliver significant impulses in tackling long-standing challenges otherwise bearing down on productivity growth and innovation potential, thereby lifting underlying growth
3. High institutional quality, with NGEU and the new MFF as exemplary advantages of EU/EMU membership, offering key support to overcome negative effects from the health crisis; while reform momentum should be revitalized on the back of the government's Recovery and Resilience Plan, challenges pertaining to the country's justice system remain in place
4. Public finances remain the sovereign's main credit weakness; despite uncertainty over possible scarring effects, as well as possible further virus variants which could pose obstacles to the economic recovery, we expect the public debt ratio to trend downwards over the medium term; the higher level of contingent liabilities may reignite some concerns for the otherwise more resilient banking sector, while sound debt management, increased debt affordability, and the track record of budget consolidation witnessed in the last decade mitigate our concerns regarding fiscal sustainability
5. Vulnerabilities entailed by Portugal's external position persist, but have been receding somewhat over the last years, due to the improving composition of the highly negative NIIP; the recently negative current account balance may take some time to return to a surplus, given an assumed slow recovery of tourism and prospectively strong domestic demand this year and next

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

Portugal's macroeconomic performance profile is characterized by a solid and stable growth record before the pandemic outbreak, which enabled the country to build on its relatively high wealth level. Despite a diversified export and production structure, tourism continues to play a key role, somewhat weighing on the economy's prospects for economic recovery. Thanks to extensive support measures, the negative impact on the labor market and corporate balance sheets has been cushioned. Still, structural deficiencies on the labor market as well as corporate indebtedness balance other credit strengths to some extent, though we have observed considerable improvement over recent years. Investment and reforms related to the Portuguese Recovery and Resilience Plan (RRP), materially aided by EU financing, should deliver decisive impulses in tackling long-standing economic and social challenges, thus prospectively boosting underlying growth going forward.

Portugal entered the corona pandemic following a phase of very solid and broad-based growth, exceeding the average GDP expansion in the euro area (EA) over the period 2015-19 (2.5% vs. 2.0%) and bolstering the country's relatively high wealth level. According to IMF estimates, Portugal's GDP per capita increased by 22.7% in this interval (EU: +21.2%). In 2020, GDP per capita stood at USD 34,043, declining by 6.5% against 2019, as the corona crisis and the required confinement measures caused real GDP to contract by 7.6% (EA: -6.4%). Measured against the GDP per capita level in the EU, Portugal's GDP per capita corresponded to 77.0% last year (2019: 78.1%), somewhat below the readings of euro area members such as Italy (92.5%) and Spain (86.9%).

Amid comparatively tight restrictions, judging by the stringency index provided by the Blavatnik School of Management, last year's steep fall in private consumption, which stripped 3.8 p.p. off GDP growth, acted as the heaviest drag on overall output performance. In light of plunging exports (-18.6%), exacerbated by the strongly affected tourism sector and declining imports (-11.9%), net exports exerted a similarly pronounced negative contribution (-3.0 p.p.). Drawing on INE data, gross value added generated by tourism shrank to 4.6% of national GVA last year, compared to 8.4% in 2019. Meanwhile, gross fixed capital formation showed a relatively mild decline in 2020 from a European perspective (-1.8%), cushioned by further expanding construction investment, whereas investment in machinery and equipment (including transport equipment) was hit hard by the pandemic, contracting by 11.5% y-o-y.

As to the current year, a third wave of Covid-19 infection cases and related confinement measures, including a nationwide lockdown starting in January and lasting well into March, caused another strong GDP decline by 3.2% q-o-q in the first quarter, mainly affecting private consumption and services exports. Goods exports, on the other hand, have shown a significant recovery over the last few quarters, but are still falling short of their pre-pandemic level as of Q2-21. Looking at monthly European Commission (EC) survey data, export order books have improved significantly from spring, matching levels seen prior to the outbreak of the pandemic by July. Overall, and against the backdrop of further easing, Q2-21 saw a vivid GDP rebound by

[1] This rating update takes into account information available until 10 September 2021.

4.9% q-o-q, which leaves the GDP level still 4.6% below its pre-crisis level (Q4-19), comparing unfavorably with the euro area as a whole (Q2-21 vs. Q4-19: -3.0%).

Tourism is likely to remain hampered by uncertainty surrounding new virus variants such as the more contagious delta variant, which caused rapidly rising infection numbers in June, leading to renewed transitory restrictions. However, from an intermediate peak at 436.2 per 100,000 people (week 29-2021), the 14-day cumulative rate has come down to 306.4 as of week 34 (ECDC). What is more, we note that Portugal is well advanced in terms of full vaccination of its adult population. According to ECDC, 84.4% of the adult population is fully vaccinated as of 6 September (EU: 69.4%). While the rollout of the digital EU Covid-19 vaccination certificate should facilitate travelling for those willing to embark on a journey, we think that it will take longer for tourism to make a full recovery. In the first seven months of 2021, the Portuguese tourism sector registered 5.2mn guests, 2.7% below the level observed in the same period of the previous year, and 65.4% lower than the number of arrivals in Jan-Jul 2019.

With that, the outlook for exports remains prone to setbacks, as also important trading partners have to cope with resurging infections in an otherwise more constructive health environment as vaccinations continue to progress. That said, we would flag that the pace of inoculations has slowed down in many places, emphasizing vulnerabilities with a view to virus mutations. Moreover, as with many other economies, the Portuguese economy is feeling the pinch of supply bottlenecks regarding a number of intermediate products such as semiconductors and chips.

While, after two consecutive declines, monthly industrial production increased in July, industrial confidence (EC data) deteriorated in July and August. This said, the EC's Economic Sentiment indicator overall brightened in August, having posted declines in the two preceding months. Other indicators continue to point to some loss of momentum, too, such as monthly retail sales which dipped in June and July. The weekly moving average of Banco de Portugal's (BdP) daily economic indicator suggests a slower growth pace for the third quarter, compared to Q2-21.

Generally, we expect private consumption to be a main driver of the ongoing recovery this year and next, with at least a partial unwinding of the abruptly increased gross household saving rate (+5.7 p.p. to 12.8% in 2020, Eurostat). Extensive fiscal support to maintain jobs successfully limited negative reverberations for the labor market in this crisis. The latter interrupted a long period of falling unemployment and ongoing job creation. From a peak at 16.2% in 2013, the annual unemployment rate had dropped to 6.5% in 2019 (INE data, LFS-adj.), while total employment growth had moderated to 0.8% in 2019. Looking at monthly data, unemployment had climbed to 8.2% in Aug-20, before trending lower. At 6.9% as of Jun-21, the rate stood only slightly above its pre-pandemic level.

Apart from the ongoing immunization process, partly extended support — among others the extraordinary support for workers' income (AERT) which also includes applications from the first quarter of this year — should continue to prove beneficial for private consumption. In addition, average monthly total gross earnings per employee seem to be picking up, following an expansion by 3.0% y-o-y in 2020 (2019: 3.1%; INE), and should be conducive to household expenditure. Between January and June 2021, earnings have averaged 4.1% y-o-y. The minimum wage was lifted by 4.7% to EUR 775.83 this year, further aiding disposable income.

Along with assumed ongoing favorable financing conditions, public and private investment is set to be backed by NextGenerationEU (NGEU), via which Portugal will receive funding in the amount of EUR 16.6bn, of which EUR 13.9bn through grants. We understand that authorities

have asked for a loan of EUR 2.7bn out of a total of EUR 14.2bn available via the RRF, and may consider asking for up to a further EUR 2.3bn in the second half of 2022. The requests have already been greenlighted on the European level, and first disbursements were made on 3 August. Moreover, Portugal can expect EUR 33.6bn in grants via the new EU Multiannual Financial Framework (MFF) 2021-27, in addition to EUR 11.2bn in grants that were left from the previous MFF until 2023. The above-EU-average absorption of the 2014-2020 ESIF funds would corroborate expectations of a reasonable pace in taking up the new funds.

Overall, we currently pencil in broad-based real GDP growth to the tune of 4.2% for this year and an acceleration to 5.3% for 2022, for now assuming that shortages of important intermediate products are a transitory phenomenon and the recovery of the tourism industry will be gradual. We assume that net exports will make a positive growth contribution this year and next. Our base scenario of the recovery gaining traction remains subject to downside risks, mainly owing to still considerable uncertainty over the evolution of this pandemic and the level of immunization against coronavirus and its mutations. The uncertainty will likely continue to weigh on tourism and related industries in particular.

With growth in real compensation per employee exceeding real labor productivity growth per person over the last few years, cost competitiveness will have to be monitored going forward. Acknowledging that 2020 can be deemed an exceptional year, real unit labor costs have developed less favorably compared to the euro area as a whole and compared to main European trading partners when considering a three-year horizon (2017-20). Over this period, Portuguese real unit labor costs have increased by 8.5% (EA: 5.4%). Prior to the crisis, Portugal's global export market share had been inching up, driven by services, which in 2019 had reached 0.66% of the global services export market (2016: 0.59%). However, the pandemic reversed this trend in 2020, leading to a decline in the services share to 0.52%. The total global export market share thus dropped from 0.43% to 0.39% last year.

Looking at non-price competitiveness, we pay some attention to the World Economic Forum's Special Global competiveness report (Dec-20), assessing economic transformation readiness based on eleven pillars, which places Portugal at rank 22 out of 37 countries considered. While the sovereign is seen among the top ten when it comes to upgrading infrastructure to accelerate the energy transition and broaden access to electricity and ICT, the report points to room for improvement, e.g. in terms of expanding care infrastructure, updating education curricula, and expanding investment in the skills needed for jobs and markets of tomorrow.

While we still await an update of the World Bank's Doing Business Report, the latest vintage, relating to 2019, pointed to a relatively favorable business environment in Portugal (39 out of 191 economies), with the sovereign occupying a middle-range position among the EU countries. The EC, meanwhile, highlights the quality of Portugal's SME sector in terms of entrepreneurship, among other things. Moreover, through the establishment of the Banco do Fomento, we expect the business environment to be further enhanced.

Following a long period of deleveraging in the private sector, thus creating space for shock-absorbing capacity, NFC debt as measured against GDP has reached a high 131.98% of GDP as of Q1-21 (Q1-20: 121.95%, BdP). Likewise, household debt has climbed in the wake of the pandemic, to 71.02% of GDP in this year's first quarter (Q1-20: 65.85%, BdP). While this does not seem excessively high, we would continue to monitor developments once moratoria expire, which is supposed to be the case at the end of this year instead of at the end of September for

families and businesses affected by the pandemic, having been extended to smooth the transition.

Portugal's potential growth is estimated to have held up relatively well in 2020, having edged down to 1.3% (EA: 0.8%, AMECO) from 1.5% in 2019. EC forecasts are for it to recover to 1.5% this year and 1.8% in 2022, continuing to compare favorably against the euro area overall (1.0% and 1.4%, respectively). In this context, we would emphasize that implementation of the RRP is set to lift the relatively low investment-to-GDP ratio, which could reverse some of the capital erosion partly seen over last years, thus strengthening prospects for potential growth.

Averaging 16.7% of GDP over the period 2011-20, Portugal's gross fixed capital formation has been well below that of the euro area (20.8% of GDP), with both public and private investment ratios showing lower levels. However, whilst capital formation in the business sector has been increasing continuously since 2014, moving closer to its ratio prior to the global financial crisis (2020: 12.6% of GDP, 2007: 13.4%), public investment-to-GDP has had more trouble catching up (2020: 2.2%, 2007: 3.2%).

For the medium-term growth outlook, expected positive effects paint a constructive picture if the RRP is implemented timely and effectively. The bulk of the RRF cash disbursements is envisaged to be made between 2022 and 2024 as per the Stability Program 2021-25 (SP21). As expressed in the RRP, Portuguese authorities estimate an average annual boost to economic growth of about 0.7 p.p. over the five-year horizon until 2025. We note that the Public Finance Council (CFP) sees upward risks for its forecasts of the output gap gradually closing over the forecast horizon 2021-25 (positive 0.2% of potential output in 2024).

We would continue to flag potential detrimental effects from ongoing high youth unemployment. Having roughly halved from 38.1% to 18.9% between 2013 and 2019, it rose again last year, and, at 27.7% as of Jun-21, was the fourth-highest in the euro area, widening the gap towards the euro area (17.3%). In this vein, we assess as positive the government's effort to tackle this pressing issue, e.g. by means of dedicated training programs for young people – as well as for unemployed people (Activar), that were extended until the end of the current year. By the same token, planned measures as per RRP to improve and enhance education and respective infrastructure as regards STEM (science, technology, engineering, mathematics) could prospectively help to alleviate long-standing challenges regarding sluggish productivity growth. The latter seems to have been held back not least by a comparatively low skill level.

Picking up on this issue, we recall that Portugal's share of working-age population (15-64y) with a low level of educational attainment, although continuously shrinking over recent years, still compares high against the euro area (2020: 44.5%, EA: 27.3%, ISCED level 0-2). In the same vein, Portugal's below-EU-average rank (19 out of then 28) in the 2020 Digital Economy and Society Index (DESI) ranking points to remaining catching-up potential in terms of productivity, and to remaining space to enhance the growth potential.

Tying in with this, Portugal's R&D expenditure, although increasing, still comes across as rather low and falling short of boosting innovation capabilities, standing at 1.4% of GDP in 2019 (EA: 2.24%). Illustrating this point further, it seems worth mentioning that Portugal's share of high-tech products in exports was the lowest in the EU in 2018 (4.0%, Eurostat). In order to tackle these well-recognized deficiencies, the RRP foresees the targeted allocation of about EUR 5.6bn towards enhancing the economy's growth potential, and the implementation of its corporations 4.0 and digital schools strategies, amongst other things.

Further to factors potentially weighing on medium-to-long-term growth prospects, we would reiterate challenges as regards Portugal's demographic outlook. Already featuring one of the highest old-age dependency ratios in the EU, standing at 34.5% in 2020 (EU: 32.0%), the ratio is projected to exhibit one of the strongest increases in the EU by 2030 (2021 Aging Report).

Institutional Structure

The sovereign's credit rating continues to be underpinned by the high quality of its institutional set-up, including benefits of its EU/EMU membership that, among others, offers access to substantial funding for structural reforms. NGEU and the new MFF are the latest examples of access to vital funding to overcome negative effects from the current health crisis, as well as to assistance in financing the modernization of the economy with regard to more digital and sustainable growth. Moreover, the small, open economy draws significant advantages for its trade activities from the large common market as well as common standards, next to access to broad and deep capital markets. We believe that the NGEU can be regarded as a boon to address the sovereign's structural bottlenecks, providing a unique opportunity to reinvigorate its reform momentum on the back of the RRP. To this end, we would pay some attention as to whether Portugal's minority government led by the Socialist Party and backed by parts of the more left-leaning political spectrum will continue to be able to implement envisaged projects/reforms in a timely manner.

Importantly, the latest set of the World Bank's Worldwide Governance Indicators (WGIs) continues to back our positive assessment of the sovereign's institutional quality. With the exception of 'control of corruption' (reference year 2019: rank 48 out of 209 overall, EA median: 42), Portugal is perceived to match or even slightly exceed the euro area median when it comes to the WGIs we assess. Having said this, we note some deterioration compared to the previous year regarding 'control of corruption' (2018: rank 42 out of 209) and 'government effectiveness' (2019: rank 34 out of 209 overall; 2018: 29). The assessment as to 'rule of law' and 'voice and accountability' was only slightly changed, with the relative rank of the former edging down by one (to 33/209), whereas the assessment of the latter was a tad more positive compared to the preceding year, leaving Portugal at rank 23 out of 209 (EA: 26).

We note that the efficiency of the justice system continues to present challenges, despite improvements seen over recent years. As illustrated by the latest EU Justice Scoreboard 2021, Portugal remains among the EU countries exhibiting the lengthiest judicial proceedings with regard to administrative cases, with an average of 846 days to resolve respective cases in the first instance (2019). Moreover, it continues to display a relatively high number of pending administrative cases per 100 inhabitants (2019: 0.7), while making more progress in reducing pending cases in litigious civil and commercial cases. Having said this, the government is addressing these issues, among other things by way of implementing rapid reaction teams and strengthening administrative arbitration centers. Apart from that, we gather that the government has proposed measures to enhance the efficiency of criminal prosecution and trials.

Further to the quality of the justice system, and notwithstanding efforts to reinforce its pool of human resources, there remains a gap compared to the targeted number of judges as set out in the legal framework. As part of the national Recovery and Resilience Plan, the budget for intensified use of digital technology in the justice system ('Digital Transition in Justice'), is increasing.

The Anti-Corruption Strategy 2020-24 has been approved by the government, but will still have to be voted on in Parliament, while with the national Anti-Corruption Mechanism a new entity was approved by government decree in May. The EC's recent Rule of Law Report also mentions improvements in terms of enhancing the transparency of legislative processes, highlighting e.g. the new Parliamentary Rules of Procedure in this respect.

While we would thus stress our general impression of the sovereign's high degree of responsiveness to policy recommendations, we are aware that the EC formally initiated an infringement procedure with regard to combating money laundering, among others against Portugal in February 2021, for having incorrectly transposed the 4th AML directive.

Turning to the topic of climate protection and energy transition, we assess as positive that Portugal remains firmly committed to reduce net emissions to zero by 2050, being an early adopter of this target. The government has set an ambitious climate and energy agenda, and published its long-term strategy for carbon neutrality back in June 2019 (RNC 2050).

Judging by greenhouse gas emissions per capita, Portugal is among the best performers in the EU, with a reading of 6.6 tons of CO2 equivalent in 2019 (EU-27: 8.4), having dropped from an intermediate peak at 7.3 tons in 2017. Its position as regards the EC's Eco-Innovation Index seems somewhat less favorable, with Portugal placed among the average innovation performers in the EU (score in 2021: 115.1, EU: 121.0), having slightly underperformed the EU as a whole since 2020 (2012 basis).

Portugal features a relatively high overall share of energy from renewable sources. As of 2019, this share was at 30.6% (EU-27: 19.7%), with a particularly high percentage of renewable sources in gross electricity consumption (53.8%, EU-27: 34.1%). By contrast, the respective share in transport is hardly higher than in the EU as a whole (9.1%, EU-27: 8.9%).

Fiscal Sustainability

We continue to assess Portugal's public finances as the main weakness with regard to its credit rating. Whilst assumed to be a temporary disruption, the corona pandemic has pushed the public debt ratio to a new high, and ongoing uncertainty over possible scarring effects as well as over further, more contagious, virus variants could pose obstacles to a normalization path. Although not the base scenario, a marked increase in defaulting loans may reignite some concerns for the otherwise more resilient banking sector. We expect the sovereign's debt-to-GDP ratio to follow a downward path over the medium term given the prospective favorable growth-interest rate differential. Sound debt management and increased debt affordability, as well as the convincing track record of fiscal consolidation following the euro area debt crisis and the composition/holding structure of government debt, continue to balance the abovementioned deficiencies to some extent, in our view. As regards more structural aspects of budgetary execution, we are aware that the effective implementation of the 2015 Budgetary Framework Law has been delayed further.

After posting a small general government surplus in 2019 (0.1% of GDP) in the wake of its recent consolidation phase, the corona pandemic took a heavy toll also on Portugal's public finances last year. Amid plunging economic output and against the backdrop of support measures for households, companies, and the health sector — which had a direct budgetary effect of about 3.3% of GDP — the general government balance swung back into a deficit of 5.7% of GDP in 2020. Liquidity support to companies and households, such as tax deferrals and loan guaran-

tees, came to about 4% of GDP. We note that one-off measures such as the Novo Banco contingent capital mechanism are also included in the 2020 deficit, which pushed the latter by about 0.5 p.p. Nevertheless, at the reported level the deficit turned out to be markedly smaller than estimated in our last review (Sep-20).

Due to the substantial effort to prevent even worse consequences for economic activity, general government expenditure was driven up by 7.8% last year (2019: 2.5%), chiefly on account of a vast increase in subsidies (321.8%), as well as rising social benefits (3.5%). Compensation of employees, which has seen solid increases over the last few years, was lifted by another 3.7% in 2020. General government revenue, on the other hand, posted a strong decline (-5.0%; 2019: 3.6%) on the back of slumping tax income, with the VAT revenue intake contracting by 10.6%, and current taxes on income and wealth by 3.7%.

Drawing on monthly budget execution data by the Budget Directorate (DGO), the general government registered a deficit of about EUR 6.84bn in Jan-Jul-21, or roughly 3.4% of 2020 GDP, constituting an improvement of about EUR 1.6bn compared to the same period of the prior year. Total revenue climbed by 8.0% compared to the respective period of 2020, amid recovering economic activity and associated rising tax intake and social contributions, while government outlays rose by 3.7%, still heavily influenced by pandemic-mitigating measures. By the end of July, the extraordinary measures to combat Covid-19 and to restore normality totaled roughly EUR 4.7bn. The bulk of the expenditure-related measures was directed towards supporting companies with the cost of labor as well as fixed costs. Social security support significantly surpassed the amount budgeted for 2021, representing almost double the budgeted sum.

The SP21 had foreseen a deficit-reducing impact of announced discretionary measures of about 0.4% of GDP overall, with (waning) temporary measures exerting an effect of about -1.2 p.p., while more permanent measures — especially related to public wage increases — were projected to increase the deficit by 0.8 p.p. However, a number of temporary measures, such as the extraordinary aid to companies for the gradual resumption of activity (APRA), the program for the support of young people and the unemployed (Activar), and the extraordinary support for workers' income (AERT) have been extended to the end of the year since. In addition, the extraordinary business viability process (PEVE), which, subject to conditions, prevents insolvencies for businesses considered to be viable, is to be in place until the end of the year as well, with a possibility for further extension, if needed.

Against this backdrop, and bearing in mind the ongoing uncertainty over the delta variant and possible further disruptions, we expect the deficit to remain relatively high at about 4.6% of GDP this year, although markedly smaller than last year, also considering positive effects from reimbursed EFSF pre-financing and transfers under REACT-EU. In 2022, the net effect of temporary and non-temporary measures was supposed to come to a deficit-reducing impact of about 0.6 p.p., again mainly via expiring temporary measures. In light of reports of the government contemplating a significant increase in family allowance in the next state budget for 2022 (OE2022), room for a strong reduction of the deficit may turn out to be limited, despite the assumed acceleration of annual GDP growth. At this stage, we tentatively pencil in a deficit of 3.3% of GDP for 2022.

In view of the anticipated economic recovery and narrowing deficit, we expect the public debt ratio to resume its downward path, from an expected level of around 127.7% of GDP this year (2022e: 122.1%). Given the assumed positive effects to the economy and the fiscal situation via the RRF-supported recovery, the government's expectation of the public debt ratio falling below

its pre-crisis level by 2025 (SP21) does appear feasible to us. Thanks to the resuming economic recovery, the ratio declined from 137.2% of GDP in Q1-21 to 133.9% in Q2-21 (BdP).

Portugal's public debt ratio was still at a relatively high level (2019: 116.8%) when the corona pandemic hit, despite having dropped substantially from a high at 132.9% of GDP in 2014. In 2020, the debt-to-GDP ratio soared by 16.8 p.p. to 133.6% of GDP on the back of plunging economic activity and the high general government deficit, continuing to represent the third-highest public debt ratio among euro area members (98.0%, EU: 90.7%).

As regards risks to the sovereign's medium-term fiscal sustainability, we have to highlight that its banking sector has shown a decent degree of resilience towards the exceptional circumstances during the last one and a half years, though materially aided by government loan guarantees and payment moratoria. Judging by recent readings of CET-1 ratios, Portuguese banks have braced themselves against the crisis by rebuilding capital, displaying a ratio of 14.7% as of Q1-21 (Q1-20: 13.7%, EBA). Nevertheless, this still compares less favorably against the EU average (Q1-21: 15.9%). As elsewhere, banks' profitability has suffered over the course of the pandemic, which has increased the burden posed by the low interest rate environment, but seems to have recovered somewhat at the beginning of the year, considering the return on assets in Q1-21 (0.3%, Q1-20: 0.2%).

We observe that asset quality has not deteriorated so far, but has improved further, mirrored by the decline in the NPL ratio as of Q1-21 (EBA data). While remaining elevated, this indicator has dropped to 4.5%. Lacking more recent data, we would, however, point to the share of stage 2 loans and advances having risen from 9.7% in Mar-20 to 11.6% in Mar-21, exceeding the share reported for the EU overall (Mar-21: 9.0%). Looking at loans and advances with non-expired moratoria, the share of stage 2 loans has surged by 8.3 p.p. to 23.7% as compared to Jun-20 (EU Q1-21: 27.3%), which could be a harbinger of future deterioration of the asset quality in the banking sector.

To this end, we reiterate that payment moratoria are to remain in place until the end of the year for those individuals and companies most affected by the pandemic, which may prove successful in preventing any potentially abrupt worsening. Drawing on Eurostat data, the number of declared insolvencies surged by 15.5% y-o-y in the second quarter, after having dwindled to a multi-year low in Q1-21.

Given the considerable pick-up in lending to the private sector over the course of the crisis, we would continue to monitor developments closely. Outstanding loans to NFCs had increased by 11.2% y-o-y in Feb-21, with this rate moderating to 5.9% y-o-y as of Jul-21 (BdP data). As of Jul-21, 28.8% of bank loans to NFCs were under moratoria. Mortgage loans to households have increased less vividly (Jul-21: 3.9% y-o-y), suggesting that dynamic house price developments were rather driven by more fundamental factors.

We would nevertheless keep an eye on house price dynamics, as affordability indicators such as the price-to-income ratio (OECD) point to some overvaluation. However, according to Eurostat data, the annual rate of change in house prices has slowed from 10.3% to 5.2% over the four quarters to Q1-21, whereas the 3-y rate of change remains well in double-digit territory, posting at 26.7% in this year's first quarter (Q1-20: 35.2%).

Further to fiscal sustainability risks stemming from contingent liabilities, we would flag an elevated level of public guarantees which has increased in the wake of this crisis. Total public guarantees amounted to 9.68% of GDP in 2020 and are expected to increase further to 11.88% of

GDP in 2021 (Ministry of Finance). The maximum amount of contingent liabilities adopted in response to the Covid-19 outbreak corresponded to 3.67% of GDP in 2020, for which there was a strong take-up amounting to 3.16% of GDP, hence about 86%, at the time of presenting the SP21. In this context, we gather that the state guarantees also cover 25% of the credit under moratoria, with the amount of claims in public and private moratoria having reportedly been set at EUR 36.8bn in July.

Notwithstanding the high debt level, and related concerns over the medium-term outlook for the debt path given still considerable uncertainty, strong debt management and a more benign debt profile along with increased debt affordability and the cash buffer remain factors significantly mitigating fiscal sustainability risks. In addition to the abovementioned RRF financing, EUR 5.41bn or about 2.7% of 2020 GDP in financial aid has so far been provided via the EC's SURE loans. The average weighted maturity (AWM) of public debt stood at 6.93y in Jun-21 (ECB), up from 6.38y in Jun-20, while the cost of outstanding debt has been continuously declining during the last ten years, standing at 2.2% in 2020, driven down by the cost of debt issuance which reached a historically low level at 0.5% in 2020 (2019: 1.1%). As of Q4-20, about 43% of sovereign debt was held by the official sector (foreign official sector, domestic central bank, IMF data).

With bond yields at or near historical lows, interest payments accelerated their decrease last year, falling by 8.6%, leaving the interest-to-GDP ratio at 2.9%, the lowest reading since 2010. Measured against total revenue, interest payments diminished to 6.7% in 2020, corresponding to the lowest ratio since 2005, but still comparing relatively high among the euro area members. Judging by current budget execution data until Jul-21, interest and other charges fell further in the first seven months of the year compared to the same period last year. As of 27 August, the yield on 10-year government bonds stood at 0.191% (weekly data), remaining not far from its all-time low reached in Dec-20. We note that the sovereign issued its first bond at a negative yield this January.

We expect the ECB's monetary policy to remain very accommodative for the time being, likely contributing to relatively favorable conditions on financial markets. Since our last review, the ECB has strengthened its accommodative stance, increasing its PEPP envelope to a total of EUR 1,850bn, while the horizon for net purchases under PEPP was extended to at least the end of March 2022. The maturing principal payments from securities purchased under the PEPP will be reinvested until at least 31 December 2023. From Mar-20 to Jul-21, the Eurosystem has made cumulative net purchases of Portuguese sovereign bonds worth EUR 27.288bn under the PEPP, corresponding to 13.5% of GDP. Meanwhile, the ECB continues its APP, with monthly net asset purchases of EUR 20bn for as long as deemed necessary.

Foreign Exposure

Vulnerabilities entailed by Portugal's external position as a pronounced net debtor persist, but have been receding somewhat over recent years. What is more, the improving composition of the highly negative NIIP mitigates risks to some extent. In view of a likely gradual recovery of tourism and prospectively strong domestic demand this year and next, it may take some time until its economy is able to return to current account surpluses as seen before the outbreak of the pandemic.

After posting sustained surpluses since 2013 (average 2013-19: 0.8% of GDP), Portugal's current account balance moved into a deficit to 1.1% of GDP last year. The sharp contraction of the surplus in services trade, shrinking by 4.1 p.p. to 4.2% amid muted tourism, was not completely

offset by the smaller deficit in goods trade and in the primary income balance. Prior to the outbreak of the Covid-19 pandemic, the surplus in the service balance had continued its upward trend, mainly mirroring increasing travel receipts, which had roughly doubled from 2013 to 2019.

As of Q2-21, the current account deficit has persisted based on a moving four-quarter sum, coming to 0.7% of GDP. Looking ahead, we expect the travel situation to remain burdened by uncertainty surrounding the evolution of coronavirus, and the current account deficit to persist this year, albeit narrowing. Depending on the degree of regained confidence in health safety, the current account should shift back into surplus going forward.

The pandemic also interrupted the improvement in the NIIP observed since 2014, as measured against GDP, due to the strong decline in total economic output which, however, should prove transitory in the face of the expected ongoing economic recovery. Portugal's highly negative NIIP deteriorated by 4.9 p.p. to -105.1% of GDP in 2020, whereas the negative position was diminishing in absolute terms. Last year, a higher negative net direct investment position in absolute terms was more than offset by a higher net positive position in portfolio investment and a higher level of reserves. Valuation effects contributed markedly to the resulting net position in portfolio investment. As of Q2-21, we observe an improving development amid rebounding growth, with the NIIP standing at -99.5% of GDP.

Despite an expected upward trajectory, we expect the NIIP to remain highly negative for the foreseeable future. We would continue to stress some mitigating factors regarding risks pertaining to position. Moreover, the share of net FDI has continued to increase. The NIIP excluding non-defaultable instruments (NENDI), amounted to a more moderate -47.1% of GDP in 2020, having materially fallen since peaking at -82.1% of GDP in 2012. Additionally, breaking down the NIIP by sector, more than half of the negative NIIP (~64% of GDP) can be attributed to the government sector, where we have observed a shift towards a somewhat healthier debt profile in the more recent past. To this end, receiving RRF grants should contribute to decreasing net external liabilities to some degree.

Rating Outlook and Sensitivity

Our rating outlook on the Republic of Portugal's long-term sovereign ratings is stable, as we see risks associated with the recent deterioration of fiscal metrics, and risks regarding the external position, as broadly balanced by the above factors mitigating fiscal risks, by the ongoing economic recovery, and by Portugal's institutional strengths. We have to reiterate that, in light of the highly dynamic epidemiological situation, any assessment and interpretation of economic and fiscal developments and prospects remains more challenging than under normal circumstances.

We could lower Portugal's credit rating or outlook if we observe that the recovery is substantially falling short of our expectations, possibly exerting deeper scarring effects via the labor market and from tourism if e.g. vaccines prove less effective against new virus variants. A resurfacing deterioration of asset quality in the event of a higher number of insolvencies weighing on the banking sector, potentially increasing pressure on public finances, could also prompt a negative rating action. More generally, failure of the public debt ratio to embark on a clear downward trajectory over the medium-term could have us consider lowering the outlook or the rating of the sovereign.

Conversely, we could consider raising Portugal's ratings or outlook if the medium-term outlook improves significantly as resilience and productivity growth is markedly strengthened amid swift and successful implementation of the measures set out in the RRP. Upward pressure on the rating or the outlook could also result from a stronger-than-expected improvement in public finances amid a strong and sustainable economic recovery, and with contingent liabilities markedly reduced.

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Ratings*

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

*) Unsolicited

ESG Factors

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

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

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

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

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

ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demographics
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liberties/ Political Participation**	Market Access	Business Environment	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

Economic Data

[in %, otherwise noted]	2015	2016	2017	2018	2019	2020	2021e
Macroeconomic Performance							
Real GDP growth	1.8	2.0	3.5	2.8	2.5	-7.6	4.2
GDP per capita (PPP, USD)	29,669	31,604	33,086	34,902	36,400	34,043	36,079
Credit to the private sector/GDP	135.4	124.9	115.1	109.0	102.0	110.7	n/a
Unemployment rate	12.6	11.2	9.0	7.1	6.5	6.8	n/a
Real unit labor costs (index 2015=100)	100.0	99.1	99.6	101.2	101.2	108.1	n/a
Ease of doing business (score)	76.4	76.7	76.5	76.4	76.5	n/a	n/a
Life expectancy at birth (years)	81.3	81.3	81.6	81.5	81.9	81.1	n/a
Institutional Structure							
WGI Rule of Law (score)	1.1	1.1	1.1	1.1	1.1	n/a	n/a
WGI Control of Corruption (score)	1.0	0.9	0.9	0.8	0.8	n/a	n/a
WGI Voice and Accountability (score)	1.1	1.2	1.2	1.2	1.2	n/a	n/a
WGI Government Effectiveness (score)	1.2	1.2	1.3	1.2	1.2	n/a	n/a
HICP inflation rate, y-o-y change	0.5	0.6	1.6	1.2	0.3	-0.1	0.8
GHG emissions (tons of CO2 equivalent p.c.)	6.8	6.7	7.3	6.9	6.6	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-4.4	-1.9	-3.0	-0.3	0.1	-5.7	-4.6
General government gross debt/GDP	131.2	131.5	126.1	121.5	116.8	133.6	127.7
Interest/revenue	10.5	9.7	8.9	7.8	6.9	6.7	n/a
Debt/revenue	299.5	306.5	297.4	283.2	274.2	312.4	n/a
Weighted average maturity of debt (years)	6.5	6.6	6.2	6.2	6.3	6.4	n/a
Foreign exposure							
Current account balance/GDP	0.2	1.2	1.3	0.6	0.4	-1.2	n/a
International reserves/imports	0.3	0.4	0.3	0.3	0.3	0.4	n/a
NIIP/GDP	-118.9	-110.5	-110.4	-106.4	-100.2	-105.1	n/a
External debt/GDP	217.1	206.9	201.1	195.6	192.0	202.8	n/a

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

Appendix

Rating History

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

Regulatory Requirements

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

This sovereign rating is an unsolicited credit rating. Agência de Gestão da Tesouraria e da Dívida Pública (IGCP) participated in the credit rating process as IGCP provided additional data and 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.

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

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

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

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

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

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

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

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

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