Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
PORTUGUESE REPUBLIC	Assigned Ratings/Outlook: **A- /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 11-08-2023 "Sovereign Ratings" "Rating Criteria and Definitions"

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Rating Action

Neuss, 11 August 2023

Creditreform Rating has raised its unsolicited long-term sovereign rating on the Portuguese Republic to "A-" from "BBB". Creditreform Rating has also raised Portugal's unsolicited ratings for foreign and local currency senior unsecured long-term debt to "A-" from "BBB". The outlook is stable.

The rating upgrade on the Portuguese Republic reflects

(i) buoyant economic growth, also driven by strong tailwinds from the tourism sector and the Portuguese economy's resilience to the energy crisis, which has resulted in strong post-pandemic increases in per capita income;

(ii) the favorable outlook for solid medium-term real GDP growth, assuming topped-up EU financing and a timely implementation of the national Recovery and Resilience Plan (RRP); and

(iii) repeated fiscal outperformance more recently and a sharp decline in the sovereign's public debt ratio coming on the back of Portugal's robust macroeconomic backdrop and significantly improved public finances as well as our expectation that the debt-to-GDP ratio will follow a firm downward path over the medium term, whilst the banking sector should remain stable.

Key Rating Drivers

1. Rapid recovery in real GDP growth, driven by a strong rebound in private consumption and tourism; underpinned by a markedly favorable performance of net exports, economic growth is set to remain robust in 2023 and 2024, albeit at a somewhat slower pace; although the Portuguese labor market has proven resilient in the face of accumulating crises, some structural deficiencies remain in place

2. Constructive medium-term prospects in light of the expected roll-out of reforms and investments under the RRP, which should boost underlying growth and further strengthen the resilience of the Portuguese economy; private sector debt remains relatively high, but deleveraging of NFCs and households has continued to progress significantly

3. Very strong institutional framework, as underscored by a consistently good performance in the Worldwide Governance Indicators (WGIs); Portugal's EU/EMU membership entails significant benefits through funding initiatives such as NextGenerationEU (NGEU) and the

Multiannual Financing Framework (MFF), which contribute to the high institutional quality; despite some political noise accompanying the government's reshuffling, we believe the stable political backdrop created by the government's outright majority in parliament will support steadfast efforts in implementing structural reforms

4. Notwithstanding a still high debt-to-GDP ratio, we assess fiscal sustainability risks as contained given the government's sound debt management and continued fiscal consolidation as well as our expectations of a positive medium-term debt trend; higher debt servicing costs are no reason for concern for the time being, as a benign debt profile balances risks to debt affordability; we continue to closely monitor Portugal's otherwise healthy banking sector, as monetary policy tightening in tandem with elevated private indebtedness could have adverse effects on financial stability

5. While vulnerabilities arising from Portugal's highly negative net external debtor position persist, external risks are somewhat mitigated by the composition of the net international investment position (NIIP) and its significant improvements observed over the last two years; the current account deficit should narrow further this year and next, approaching a broadly balanced position in the medium term, partly driven by the huge demand for tourist-related services and receding commodity prices

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

Portugal's credit rating mirrors its overall solid macroeconomic profile, featuring robust economic growth, which was briefly interrupted by the pandemic slump in 2020 and has translated into a brisk increase in GDP per capita. Despite the energy price shock, Portugal's economic growth outpaced the euro area's (EA), and we expect it to remain robust this year and next. The Portuguese labor market has withstood the recent succession of crises relatively well, although some structural shortcomings persist. Aided by EU funding related to NGEU and the MFF 2021-2027, medium-term economic perspectives appear constructive. Successful negotiations with the European Commission (EC) on the modification of Portugal's RRP would contribute to this, as it would entail a much larger volume of EU financing. Recent productivity developments have surprised on the upside, and prospects for a further strengthening are promising. Medium-term risks to economic growth stem from the still elevated level of private indebtedness, which has, however, declined significantly in recent years.

Despite the negative impact on inflation, the Portuguese economy has hitherto weathered the geopolitical shock remarkably well. With an expansion of 6.7% in 2022, economic growth even accelerated compared to the previous year. In 2022, real GDP was 9.0% higher than in 2017, which compares with 5.9% in the euro area.

Last year's economic expansion was largely driven by private consumption, which contributed 3.8 p.p. to output growth alone. Following a strong recovery in tourism, net exports also made a significant contribution (+2.0 p.p.). Services exports rose by 60.5% in 2022, exceeding the pre-pandemic level by 23.7% (Eurostat, BPM6 data). The sharp increase in overall services exports

[1] This rating update takes into account information available until 04 August 2023.

came on the back of travel, transport, ICT and other business-related services. Gross fixed capital formation and public consumption also exerted a positive impact on real GDP growth.

Strong real GDP growth has led to a sharp increase in Portuguese per capita incomes, providing key support to our credit rating. According to IMF estimates, Portugal's GDP per capita grew strongly by 14.2% last year to USD 42,634 (current prices, PPP). After losing some ground, Portugal's GDP p.c. corresponded to roughly 78% of the weighted EU average, up from 76% in 2021.

Portugal's economy got off to a good start in 2023, with real economic activity expanding by a 1.6% q-o-q (EA: 0.0%), mainly driven by net external trade, in turn bolstered by further recovering tourist arrivals and easing supply chain challenges. Household spending supported GDP growth as well. According to flash estimates, Portuguese real GDP growth stagnated in the second quarter after the strong increase in Q1, but grew by 2.3% in y-o-y terms (EA: 0.6% y-o-y). Economic sentiment improved slightly in June and July to a higher level than at the end of 2022.

In our view, tourism, and more generally net exports, will remain a vital pillar of real GDP growth this year and next. Judging by INE data on overnight stays, the number of non-resident overnight stays increased by 24.2% in the first half of 2023 compared to the same period of the previous year. Furthermore, the number of non-resident overnight stays in the first half of 2023 was 9.6%% higher than in the corresponding time period of 2019. We expect the tourism sector to perform strongly in the remainder of the year, in particular in August against the backdrop of Lisbon hosting the World Youth Day, which should bode well for tourism receipts. In this context, we note that revenues from hotel accommodation over the period January to May 2023 exceeded the collected revenue for the same period in 2019 by 43.8%, underscoring that Portuguese tourism has been left largely unscathed by the recent succession of crises. Sentiment in the retail and services sectors was optimistic, surpassing their respective readings at the end of 2022.

Although goods exports may be impacted by softening foreign demand as the year progresses, amid slowing economic activity in some of the main trading partners, in particular Germany, we expect overall export growth to outpace import demand for goods and services given the strength of services exports, resulting in a positive contribution from net external trade in 2023. As we forecast domestic demand to strengthen from the second half of this year, net export's growth contribution should turn broadly neutral in 2024.

Inflation and rising financing costs are likely to curb private consumption this year. After peaking at 10.6% in October 2022, headline inflation in Portugal has recently fallen below that of the euro area, while most other euro area economies recorded much higher inflation rates. The containment of inflation to around the euro area average was mainly due to the so-called Iberian mechanism, which subsidizes the difference between the market price and a fixed price cap for energy obtained from fossil fuel plants.

Originally set to expire in May, the adjustment mechanism was extended until the end of 2023 by Royal Decree Law 21-B/2023, March 30, 2023, which should prevent the materialization of further massive price surges. That said, Portugal's economy remains highly dependent on fossil fuels, with oil and petroleum products accounting for 42.4% of its energy mix in 2021, whereas the import of oil (and petroleum products) from Russia stood at a low 5.6%. Natural gas, which is heavily used in electricity generation, accounted for 23.1% of Portugal's energy mix in 2021.

Triggered by the fall in energy prices, HICP inflation dropped to 4.3% in July. The recent decrease in consumer prices was also driven by a VAT exemption on food products, which is in effect from

18 April to the end of October. Core inflation (excluding energy, food, alcohol and tobacco), however, appears to be stickier and has been trending upwards since the beginning of this year, hovering around 6.4% between April and June. We expect consumer prices to recede significantly compared to last year.

Real disposable income will be backed by energy support measures, a 7.8% increase in the minimum wage from January 2023 and continued wage growth – total gross earnings rose by 7.4% in March 2023 (INE data, y-o-y). While we expect inflation to further moderate and private consumption to gradually recover from next year, tighter financing conditions should continue to weigh on households' purchasing power, not least because the lion's share of mortgage loans is set at a variable rate. According to Banco de Portugal (BdP) intelligence, roughly 90% of mortgage loans were granted at variable interest rates, implying a significant increase in debt servicing costs for households as interest rates rise. Accordingly, consumer sentiment remains downbeat, although it seems to have bottomed out last September.

Deteriorating financing conditions are also clouding the outlook for private fixed investment. We expect businesses to act cautiously, cut back investment expenditure and postpone plans into the future. Survey data show that industrial new orders have been in negative territory for five consecutive quarters, and industrial sentiment has been pessimistic throughout the first sixth months of this year.

On the other hand, gross fixed capital formation should benefit from public investment activity related to NGEU and the MFF. Following the positive assessment of Portugal's payment request, the EC disbursed the second tranche under the RRF comprising EUR 1.8bn this February. We also note that Portugal submitted a request over the modification of its RRP and the addition of a REPowerEU chapter in May. The latter covers 6 reforms and 18 investments with a focus on promoting the production of climate technologies.

Other key issues addressed by the modified RRP include the increased allocation of RRF grants to EUR 15.5bn, the effect of supply chain bottlenecks and inflationary pressures as well as a request for EUR 3.2bn in additional loans. If the negotiations with the EC proceed favorably, the updated RRP will include a total financial envelope of EUR 22.2bn, which would be over 33% higher than initially envisaged. As of August, roughly 13% of EU financing has been disbursed to beneficiaries.

Overall, we expect real GDP growth to decelerate this year, but come in at 2.4%, which we consider as high in the current challenging economic environment, with robust net exports providing the main support to economic activity. Assuming that quarterly growth gains traction in the second half of this year, we forecast that real GDP will expand by 2.0% in 2024, emphasizing elevated uncertainty surrounding these projections against the backdrop of the geopolitical situation in Ukraine and more severe consequences for the real economy emanating from monetary policy tightening.

Medium-term prospects appear constructive, given the huge amount of funds made available under the MFF 2021-2027, in addition to the NGEU funds, and the fact that Portugal absorbed a substantial share of EU funds related to the MFF 2014-2020 cycle. As of 27 July 2023, the corresponding absorption rate stood at 97%, lending confidence that the new funds will be spent efficiently and in a timely manner. With the total allocation of EU cohesion policy funds for the 2021-2027 cycle amounting to EUR 30.9bn, public investment and underlying growth should be strengthened in the medium term.

Posting at 2.0% and 2.1%, respectively, Portugal's estimated potential growth rates for 2023 and 2024 (AMECO data) compare favorably not only with Spain and the euro area as a whole, but also with its five-year average for the 2015-2019 period, which recorded a much lower value of 1.2%. That said, we would flag the longer-term development of potential growth in light of the projection that the share of working-age population is about to shrink, which could weigh on potential growth further out.

Portugal's labor market conditions remained quite favorable. The Portuguese unemployment rate reached a multi-year low in 2022 (6.0%), falling below the euro area level (2022: 6.8%). Looking at monthly Eurostat data, the unemployment rate came in at 6.4% in June, on par with the euro area reading. Labor participation developed positively as well, reaching 77.2% as of Q1-23, comparing favorably against the euro area level of 74.9%. With employment growth of 2.0% in 2022, we see that Portugal somewhat trailed the euro area (2.8%) in terms of job creation.

Structural labor market challenges related to the precarious youth unemployment situation and the relatively high share of low-skilled workers in employment persist. At 17.2% (June-23, Eurostat), Portugal's youth unemployment rate stood well above the euro area reading (13.8%). The share of young people in temporary jobs has declined by several percentage points over last year, but continues to exceed the euro area level. Concerning people aged 15 to 64, we note that the share of low-skilled persons in employment was almost twice as high as in the euro area as a whole. To be sure, policies such as the Decent Work Agenda, which entered into force in May and the tripartite agreement signed by the Portuguese government, leaders of the employers' confederation and the trade union last October will help to address labor market deficiencies.

While Portugal's nominal labor productivity per person and per hour worked as a percentage of the EU-27 level were among the lower readings within the group of EU countries, we took note of improvements in 2022. Moreover, real unit labor costs have compared favorably against most trading partners of late, as growth of real labor productivity per person outpaced the rise of real compensation per employee by a considerable margin. By the same token, Portugal's global export market share of goods and services increased from 0.38% to 0.41% last year, with the global export market share of services rising considerably to 0.67% (2021: 0.53%, Eurostat).

After moving up by three places in the 2023 vintage of the IMD World Competitiveness Ranking, Portugal returned to its pre-pandemic position, occupying a middle-range rank 39 out of 64 participating economies. At the same time, Portugal performs well in terms of innovation capacity, achieving a strong 32 place out of 132 countries featured in the UN's Global Innovation Index 2022. Particular strengths were in 'human capital and research' as well as 'creative outputs'. Awaiting the Digital Economy and Society Index 2023, we reiterate that Portugal recorded a marked improvement in the integration of digital technology in business activities in the 2022 version, resulting in an overall rank of 15.

Risks to the constructive medium-term outlook, albeit gradually diminishing, stem from the still pronounced level of private indebtedness. Although Portugal's NFC debt-to-GDP ratio remains elevated from an EU-27 perspective (79.7% as of Q1-23), we highlight that it has continued its downward trajectory over the last year. The annual growth rate of banks' outstanding loans to NFCs has decelerated over the last 12 months and even turned negative, posting at -3.7% y-o-y this May (May-22: +1.4%). Drawing on BdP data, the debt level of state-owned NFCs fell by more than EUR 200mn y-o-y (May 2023) to approximately EUR 7.2bn.

Household debt measured against disposable income fell by several percentage points as compared to last year, reaching its lowest level since 2001 in this year's first quarter. As mentioned above, the share of variable-rate loans in total housing loans is substantial, which, given the ongoing rise in interest rates is associated with rising debt servicing cost and could entail adverse implications for the banking sector (see below).

Institutional Structure

The sovereign's very strong institutional framework, reflected in the latest update of the World Bank's WGIs, is a key pillar of our credit assessment. As a small and open economy, Portugal benefits significantly from its EU/EMU membership, including substantial EU financing through the RRF and MFF as well as access to deep and integrated capital markets. Progress has been made in enhancing the quality of the justice system, while challenges related to its efficiency and combating corruption remain in place. We think that the government will make headway in implementing structural reforms, essentially in line with the RRP, supported by the stable political environment provided by the government's absolute majority in parliament. Portugal's firm commitment to making the transition to becoming a carbon-neutral economy is mirrored in the strong performance of its environmental metrics, laying the foundations for achieving its climate targets.

Looking at the latest vintage of the WGIs, which refers to the reference year 2021 and forms the basis of our assessment of the sovereign's institutional quality, we see only minor changes compared to the previous update. Thus, the overall institutional quality remains high, with Portugal being broadly in line with, or even above, the respective euro area averages (median) in each of the four indicators on which we put the greatest emphasis.

More specifically, the sovereign maintained its 32nd rank (out of 209 economies, EA median: 34) in terms of the perceived quality of courts, property rights and contract enforcement (WGI 'rule of law'), which has seen only little movement in recent years, and its 22nd rank (out of 208 economies, EA median: 29) regarding 'voice and accountability', underscoring the perceived high degree of freedom of expression, freedom of association and free media, as well as participation in the selection of the government. With a view to the perceived quality of policy formulation and implementation (WGI 'government effectiveness'), Portugal slipped by one place to rank 41 (out of 209 economies, EA median: 38), whereas it improved by one position to rank 47 (out of 209 economies, EA median: 45) regarding 'control of corruption'.

In the context of corruption, GRECO's second compliance report of the fourth evaluation round (Sep-22) indicates some room for improvement, as seven out of fifteen recommendations have been partly implemented and five recommendations have yet to be implemented. As a result, only three out of fifteen recommendations were implemented satisfactorily or dealt with in a satisfactory manner. According to GRECO, the enforcement of foreign bribery could be improved, with allegations of high-level corruption not being investigated thoroughly. On a positive note, the implementation of the National Anti-Corruption Strategy for 2020-2024 is ongoing, and the instalment of the National Anti-Corruption Mechanism (MENAC) took place this June, following its creation in December 2021.

Digital technology is highly integrated into the court operations, reflecting the advanced digitalization and overall good quality of the Portuguese justice system. According to the EU Justice Scoreboard 2023, 2021 saw more civil and commercial cases as well as administrative cases resolved than new ones coming in. While challenges pertaining to the length of court proceedings persist, we are aware that several measures are being considered to increase the efficiency of administrative and tax courts in particular.

As regards greening the economy, Portugal has set ambitious goals to become carbon neutral. As a European pioneer in the development of renewable hydrogen development, Portugal is well positioned to drive the decarbonization of its economy. That said, further measures are likely to be required to achieve the targets codified in the Climate Law, as echoed in the OECD's Environmental Performance Review (2023). In addition, climate-related hazards such as floods, droughts and forest fires pose severe risks to the Portuguese economy, in particular to agriculture, tourism, and the generation of hydro-electric power.

Having said this, Portugal is among the best performers in the euro area when it comes to greenhouse gas (GHG) emissions and the share of energy from renewable sources. Regarding the latter, Portugal exhibited the fourth highest reading in the euro area, posting at 34.0% in 2021 (EA-20: 20.7%). Furthermore, the share of renewable energy used in gross electricity consumption accounted for 58.4% in 2021, exceeding the euro area level by a wide margin (EA: 37.8%). Portugal's GHG emissions per capita continued to follow its downward trajectory, totaling 5.6 tons per head in 2021, representing the second lowest reading among the euro area countries. There is scope to improve in terms of its eco-innovation performance, with a middle range rank among the EU-27 member states (2022).

Fiscal Sustainability

While Portugal's public debt ratio remains among the highest in the euro area, there has been significant progress in lowering its debt-to-GDP following the pandemic-induced leap, with the ratio falling below its 2019 level last year, on the back of strong nominal growth and a better-than-expected outturn of the general government balance. Following the drag posed by the acute Covid-19 phase, the primary balance turned positive last year. We expect the debt-to-GDP ratio to remain on a marked downward trajectory over the medium term, given a constructive macroeconomic backdrop and the track record of fiscal discipline over recent years, which lends confidence that authorities' firm commitment to fiscal prudence will translate into more favorable fiscal metrics going forward. High debt affordability, notwithstanding rising interest payments, as well as a benign maturity structure and diversified investor base continue to act as risk mitigants. Whilst the banking sector has weathered the recent succession of crises relatively well and asset quality has improved, we will continue to monitor developments related to mortgage lending amid the ongoing monetary policy tightening and high share of variable rate loans. In addition to previous and more recent macroprudential recommendations, there are signs that the higher interest rate environment is starting to slow down developments related to the overvalued residential property prices.

Portugal's general government deficit narrowed markedly to -0.4% of GDP in 2022 (2021: -2.9% of GDP), proving considerably lower than projected in our last review (Sep-22: -1.1% of GDP) and compared to the five-year average over the period 2015-19 (-1.9% of GDP). The improvement came on the back of substantially increased tax revenue, with current taxes on income and wealth and VAT rising by 24.1% and 18.1%, respectively, as well as on the back of a substantial increase in net social contributions (+8.6%). Taken together, total general government revenue mounted by 10.2% (2021: 10.6%).

Total general government outlays increased by 4.4% overall (2021: 3.8%), partly driven by final consumption expenditure (+5.9%) and public wages (+3.5%). At the same time, subsidies fell by 40.4% as a result of the phasing out of pandemic-induced spending, more than offsetting the negative budgetary impact of measures adopted to cushion the blow of soaring energy prices on households and businesses. Interest payments declined by 9.4% y-o-y last year, which, combined with rising total general government revenue, led to a further reduction in the interest-to-revenue ratio to 4.4% in 2022.

As regards budget execution data for the current year until June-23, we note that total general government revenue grew by 14.1% y-o-y (cash basis), thanks to climbing tax receipts and social security contributions as well as a sharp boost in capital transfers. On the other hand, mounting by 6.5%, total general government outlays expanded on the heels of higher employee compensation.

Following the surge in commodity prices, the Portuguese government introduced a series of support measures, some of which have been extended until 2023 or supplemented by new elements, thus weighing on this year's public finances. Some key measures include lump-sum payments to disproportionally affected households, and VAT exemption on essential goods between April and October 2023. The rise in remunerations and pensions for civil servants is permanent. Other fiscal measures include reductions in the fuel tax and VAT on electricity, while the planned increase in the carbon tax has been suspended. Furthermore, and as mentioned above, the 'Iberian mechanism' will remain in place until the end of 2023, rather than expiring in May. The total impact of fiscal measures related to the energy crisis should amount to about EUR 3bn (Ministry of Finance data).

In addition to the measures taken in response to the energy price shock, the 'More Housing' law was approved by parliament in July and is now subject to final approval by the President. Among other things, the package includes exemptions from capital gains tax on the sale of houses to the state, with the aim to increase housing supply. Apart from that, the package foresees termination of aspects of the so-called 'golden visa' program.

Overall, we expect the general government to post a balanced budget of 0.0% of GDP in 2023 and 2024. It has to be emphasized that these projections remain subject to elevated uncertainty in light of unpredictable events related to the war in Ukraine.

With a view to the medium term, the government is targeting a small budget surplus, which we consider feasible, not least given our assumption of a constructive medium-term macroeconomic outlook. Moreover, flanking the positive impression of recent budget execution outperformances, we note that VAT compliance has been steadily improving since 2013. While some pandemic-related distortions cannot be ruled out for the more recent phase, latest available estimates of the VAT gap as a percentage of the VTTL, concerning the year 2020, point to further decrease to 8.0% in 2020, below the EU-27 level of 9.1%.

On the issue of the ongoing public finance reform, we note that there has been some progress in the implementation of the 2015 Budgetary Framework Law, as also suggested by a recent report by the Tribunal de Contas (Jul-23), while there remain a number of challenges to be addressed, including in terms of the accounting and methodological framework of reference and internal control and audit model.

Amid the decreasing deficit and strong nominal growth, Portugal's debt-to-GDP ratio dropped sharply from 125.4% in 2021 to 113.9% in 2022. Following two years in negative territory, the primary balance turned positive last year (1.6% of GDP), with lower interest payments adding to improving fiscal metrics. We assume government debt will ultimately remain on its downward path, with the debt-to-GDP ratio declining markedly to 107.0% in 2023 and 102.0% in 2024, aided again by favorable snowball and primary balance effects.

According to the Stability Program 2023, out of a maximum amount of contingent liabilities of 4.1% of GDP in response to Covid-19, 2.7% were estimated to have been taken up. For 2023 as a whole, the Ministry of Finance projects contingent liabilities to remain stable at 7.8% of GDP, pointing to moderate risks from this angle.

Overall, risks to fiscal sustainability are mitigated by high, albeit somewhat worsening, debt affordability, the authorities' strong commitment towards fiscal consolidation and a track record of fiscal discipline in recent years. In addition, Portugal's public debt portfolio exhibits a benign maturity profile and rests on a diversified investor base. The average weighted maturity amounted to 7.3 years as of June 2023, up from 6.8 years one year before (ECB data).

Debt held by the official sector accounted for 55% of the total debt portfolio as of Q4-22 (foreign official sector, domestic central bank, IMF data), serving as further risk-mitigating factors. As far as servicing of EFSM/EFSF debt is concerned, we are aware that the next EFSM repayment of EUR 1.5bn is scheduled to take place this year, while the next EFSF repayment is not due until 2025.

Tying in on less benign capital market conditions, the ECB decided to raise its key policy rates by a further 25bp at its monetary policy meeting in July, but left the door open for a pause in September, depending on incoming data. We expect the ECB to raise rates one more time by 25bp over the remainder of the year, while in our view a first rate cut will not occur until the second half of 2024. Meanwhile, the Asset Purchase Program portfolio is shrinking gradually, as principal payments from maturing securities are no longer reinvested since July 2023. At the same time, principal payments of maturing government bonds under the PEPP will be reinvested until at least the end of 2024.

Judging by metrics capturing capitalization and asset quality, Portugal's banking sector has proved resilient throughout the recent crises. Rising interest rates contributed to banks' profitability, as most mortgage loans are subject to a variable interest rate. Return on assets increased to 1.2% in Q1-23 from 0.8% the year before (EBA data). Despite maintaining a marked gap towards the EU level, asset quality as measured by the NPL ratio improved as compared to the previous year, posting at 3.1% in this year's first quarter (EU: 1.8%, EBA data), thus continuing a downward trend. Similarly, banks' capitalization level increased, as evidenced by a rise in the CET1 ratio to 15.1%, but remained below the EU average (Q1-23: 17.1%).

We will continue to monitor financial stability risks stemming in part from the substantial share of floating-rate mortgages, as this leaves households vulnerable to financial tightening, limiting their debt servicing ability and potentially leading to a deterioration in banks' asset quality. As of Jun-23, the share of total residential property loans granted at a variable rate stood at 87.3% (BdP data). That said, a number of macroprudential measures have been introduced over the last few years, including in 2022, to counter potential risks linked to credit exposure. Moreover, the government's aforementioned housing law offers some relief to families paying off mortgage debt and requires banks to offer fixed-rate mortgages.

At 41.0% (Apr-23), the share of mortgage loans in total outstanding loans to the private sector compares as relatively moderate by European standards, and it has been declining over the last year. The annual growth rate of outstanding loans for house purchases moderated to 0.8% in May (May 2022: 2.1%), with the most recent ECB Bank Lending Survey (Jul-23), relating to developments for Q2-23, hinting at further diminishing demand for mortgage loans from households.

In connection with a cooling housing market, we will also pay attention to signs of any larger price corrections. Drawing on Eurostat data, house price growth decelerated markedly to 8.7% y-o-y in Q1-23 (Q1-22: 12.9%). However, bearing in mind that the vast majority of loans has LTVs of 80% or less, risks to the stability of the financial system in the event of a price correction should be limited.

Foreign Exposure

Portugal remains vulnerable to external shocks, as reflected by its large net external debtor position, which continues to weigh on our credit assessment. However, Portugal's NIIP has again improved significantly, and risks are mitigated to some degree by its composition. The current account deficit has recently started to shrink on the back of strong tourism and looks set to continue to narrow over the medium term.

Portugal's current account deficit widened to 1.3% of GDP in 2022, close to its long-term average (2010-2019: -1.2% of GDP). The slight deterioration compared to 2021 was due to the price effect of commodities, leaving the goods balance in deeply negative territory (-11.1% of GDP). At the same time, services exceeded pre-pandemic levels measured as a percentage of GDP, thanks to the strong rebound of tourist-related activities.

More recently, softening energy prices have led to a partial reversal of last year's developments, while services continued to expand, resulting in a narrowing of the current account deficit to -0.4% of GDP in Q1-23, calculated as a four-quarter average. With energy price effects set to fade, we expect the current account deficit to decrease further this year, before reaching a broadly balanced position over the medium term.

Whilst exhibiting one of the most negative positions among the EU-27 countries, Portugal's NIIP narrowed by 9 p.p., reaching -84.0% of GDP in 2022. The marked change came mainly on the back of a larger swing in the 'other investment' component. Highlighting underlying improvements, the NIIP excluding non-defaultable instruments narrowed further to -29.4% of GDP in 2022. In particular, external risks remain somewhat mitigated by substantial inflows of foreign direct investment. Drawing on latest Eurostat data (Q1-23), the NIIP became even less negative, standing at -80.8%.

Rating Outlook and Sensitivity

Our rating outlook on Portugal's long-term credit ratings is stable, as the improved macroeconomic performance and our expectations of constructive medium-term economic growth, which should help to keep the public debt ratio on a downward path, balance risks to fiscal sustainability and with regard to foreign exposure.

We could consider raising the rating or the outlook, if the economy continues to outperform growth expectations, translating into a further significant reduction of the debt-to-GDP ratio. Signs of improved productivity levels becoming more entrenched as a result of the implementation of EU initiatives would add positively in this regard and could also lead to an upward revision of the rating, as could further diminishing risks associated with private indebtedness and repeated outperformance of fiscal targets.

Conversely, a negative rating action could be prompted by a significantly lower-than-expected economic growth, possibly in connection with an escalation of the geopolitical conflict entailing a substantial and likely protracted deterioration in trade flows and tourism. We could also consider a downward revision of our outlook or the ratings if the public debt trajectory reverses, potentially as a consequence of the risk scenario described above and amid significant delays in RRP implementation. A negative rating action could also be warranted if materializing credit risk leads to a sharp deterioration in asset quality, weighing on banking sector stability and potentially resulting in the realization of contingent liability risks.

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Ratings*

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

*) Unsolicited

ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

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 the following, we explain how and to what 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 to 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.

ESG Factor Box

Environ-mental Quality	Ecological Risks	Ressource Management	Education	Health	Demo-graphics
Labor	Equality	Technology & Infrastructure	Safety & Security	**Judicial System**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liber-ties/ Political Participation**	Market Access	Business Environment	Data Transparency

Environment	**Social**	**Governance**	**Highly significant**	**Significant**	**Less significant**	**Hardly significant**

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 exert 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 on public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022e	2023e
Macroeconomic Performance							
Real GDP growth	3.5	2.8	2.7	-8.3	5.5	6.7	2.4
GDP per capita (PPP, USD)	33,086	34,903	36,473	33,847	37,332	42,634	44,707
Credit to the private sector/GDP	115.1	109.0	101.8	111.8	106.3	95.6	n/a
Unemployment rate	9.2	7.2	6.7	7.0	6.6	6.0	n/a
Real unit labor costs (index 2015=100)	99.6	101.2	102.2	109.0	108.0	104.9	102.8
World Competitiveness Ranking (rank)	39	33	39	37	36	42	39
Life expectancy at birth (years)	81.6	81.5	81.9	81.1	81.5	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	1.1	1.1	1.1	1.2	1.1	n/a	n/a
WGI Control of Corruption (score)	0.9	0.8	0.8	0.7	0.8	n/a	n/a
WGI Voice and Accountability (score)	1.2	1.2	1.2	1.3	1.3	n/a	n/a
WGI Government Effectiveness (score)	1.3	1.2	1.2	1.0	1.0	n/a	n/a
HICP inflation rate, y-o-y change	1.6	1.2	0.3	-0.1	0.9	8.1	5.3
GHG emissions (tons of CO2 equivalent p.c.)	7.3	7.0	6.7	5.8	5.6	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	-3.0	-0.3	0.1	-5.8	-2.9	-0.4	0.0
General government gross debt/GDP	126.1	121.5	116.6	134.9	125.4	113.9	107.0
Interest/revenue	8.9	7.8	6.9	6.6	5.4	4.4	n/a
Debt/revenue	297.4	283.2	273.9	310.6	279.5	256.8	n/a
Total residual maturity of debt securities (years)	6.2	6.2	6.3	6.4	6.9	7.0	n/a
Foreign exposure							
Current account balance/GDP	1.3	0.6	0.4	-1.0	-0.8	-1.3	n/a
International reserves/imports	33.1	28.0	27.9	37.9	33.2	28.2	n/a
NIIP/GDP	-110.4	-106.4	-100.0	-104.6	-95.0	-84.0	n/a
External debt/GDP	201.1	195.6	191.6	204.8	191.0	168.1	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
Monitoring	09.09.2022	BBB /positive
Monitoring	11.08.2023	A- /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. The Agência de Gestão da Tesouraria e da Dívida Pública (IGCP) participated in the credit rating process as it provided additional data and information, held a conference call with Creditreform Rating staff, 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 rating outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	YES
With Access to Management	YES

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, IMD Business School, 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 the event 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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