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In-Depth Review for Portugal

in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Accompanying the

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy

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The 2021 Alert Mechanism Report concluded that an in-depth review should be undertaken for Portugal to examine further the persistence of imbalances or their unwinding. In February 2020, under the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified “macroeconomic imbalances” in Portugal. These imbalances related to high net external liabilities, private sector and government debt as well as a high share of non-performing loans (NPLs) in a context of low productivity growth. The analysis shows that these vulnerabilities remain. It should be noted that the context of the assessment of vulnerabilities in this year’s in-depth review (IDR) for Portugal is markedly different from last year. Also, the evolution of the COVID-19 pandemic, the strength of the recovery, and possible structural implications of the crisis are all still surrounded by high uncertainty, requiring caution in the assessment. In general, policy action over the past year focused on cushioning the impact of the COVID-19 shock and facilitating the recovery. This has added to indebtedness but should support adjustment in the medium-term. Looking forward, the Recovery and Resilience Plan provides an opportunity to address imbalances, investment and reforms needs.

Main observations and findings of this IDR analysis are:

- **This IDR is informed by the 2021 spring forecast, which expects a recovery in economic activity in Portugal with the easing of the COVID-19 crisis.** After the steep drop of 7.6% in 2020, real GDP is projected to increase by 3.9% this year and 5.1% next year, allowing the economy to recover its pre-pandemic level by the end of 2022.

- **The external position remains weak.** The current account balance deteriorated from a small surplus in 2019 to a deficit of 1.2% of GDP in 2020 and is set to improve only marginally by 2022. As of the end of 2020, the NIIP stood at -105.4% of GDP, deviating significantly from the estimated prudential and fundamentals-explained thresholds. Non-defaultable instruments accounted for about half of the NIIP, composed mostly of foreign direct investments (FDI), which partly offset the risks of outflows related to abrupt changes in the external market environment. Over the medium term, the country’s external position is expected to benefit from the grants assigned to Portugal under the EU’s Recovery and Resilience Facility (RRF).

- **Private indebtedness rose in 2020 due mainly to GDP contraction.** After a steady decline in the period of 2012-2019, the private debt ratio increased substantially to around 160% as of the end of 2020 due mainly to the contraction in GDP. On the positive side, both households’ and corporates’ deposits increased, providing the private sector with a liquidity buffer to face potential financial problems. As the recovery takes hold, private indebtedness is set to return on a downward path.

- **Public debt is high and increased in 2020 due to the combined effect of the economic contraction and the measures to address the COVID-19 pandemic and support the economy**. The public debt-to-GDP ratio increased from 116.8% in 2019 to 133.6% in 2020 after several years of a steady decline. Nevertheless, continuous efforts in the past to smoothen the redemption profile of public debt, extend the debt maturity, and contain interest expenditure, have mitigated vulnerabilities. Public indebtedness is projected to resume its downward path as of 2021, but it will take several years to return to its pre-crisis level.

- **Productivity indicators encountered significant volatility during the COVID-19 pandemic.** Productivity in terms of output per employee dropped dramatically in 2020 as GDP contracted much faster than employment. On the other hand, productivity in terms of output per hour worked improved. Similar developments took place in the main trading partners and in relative terms labour costs and competitiveness indicators do not cause immediate concerns. The expected economic recovery is set to improve the country’s productivity as GDP is forecast to grow faster than employment in 2021-2022. Potential growth is also projected to rebound and to reach or even exceed its pre-crisis level in 2022 due mainly to the expected increase in the investment ratio. Policy efforts to boost productivity remain essential for improving Portugal’s competitiveness and potential growth and to accelerate the pace of external rebalancing.

1. ASSESSMENT OF MACROECONOMIC IMBALANCES

Introduction

In February 2020, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified "macroeconomic imbalances" in Portugal. These imbalances related in particular to high net external liabilities, private sector and government debt as well as a high share of non-performing loans (NPLs) in a context of low productivity growth. The 2021 Alert Mechanism Report published in November 2020 concluded that a new in-depth review should be undertaken for Portugal with a view to assess the persistence or unwinding of imbalances.

The context of the assessment of vulnerabilities this year is markedly different from last year's IDRs, which took place before the COVID-19 pandemic. The evolution of the pandemic, the strength of the recovery, and possible structural implications of the crisis are still surrounded by high uncertainty requiring caution in the assessment. Policy action over the past year focused on cushioning the impact of the COVID-19 shock and on facilitating the recovery. While this supports adjustment in the medium-term through stronger fundamentals, it also has added to indebtedness. Follow-up to country-specific recommendations from 2019 and 2020, including those that are MIP-relevant, is taking place in the context of the assessment of the Recovery and Resilience Plans (RRPs). The analysis of policies in the present report was finalised before the formal submission of RRPs and does not draw on information included in RRPs. It is therefore without prejudice to the Commission's assessment of RRPs, which is ongoing at the time of publication of this report.

The assessment follows a similar structure as the IDRs that were included in Country Reports in recent annual cycles. This chapter presents the main findings for the assessment of imbalances, also summarised in the MIP assessment matrix. The assessment is backed by selected thematic chapters that look more at length at the external position and private debt developments. Spill-overs and systemic cross-border implications of imbalances are also taken into account. In addition, also assessments of structural issues made in previous IDRs and in the context of fiscal assessments are considered if relevant.

Macroeconomic context

Following a decline by 7.6% in 2020, the Portuguese economy is projected to rebound by 3.9% in 2021 and 5.1% in 2022. The economy is set to return to its pre-crisis level in the middle of 2022, although the country's large hospitality sector is not projected to fully recover before the end of 2022. The economic recovery is projected to gradually narrow the output gap to a slightly negative value in 2022, and potential growth is set to move back to its pre-pandemic level. Unemployment is also projected to return to its pre-pandemic level of around 6.5% in 2022. Inflation is forecast to pick up gradually from -0.1% in 2020 to 0.9% in 2021 and 1.1% in 2022. After posting a deficit of 1.2% of GDP in 2020, due mainly to a steep drop in travel receipts, the current account is projected to improve somewhat in 2021 and 2022 but to remain on a negative territory. The economic recovery is also set to resume the positive downward trend in the country's debt ratios, both in the private and public sectors, but they are expected to remain above their pre-pandemic levels by the end of 2022.

Domestic demand, helped by the implementation of the Recovery and Resilience Plan, is the main driver behind the projected recovery in Portugal. The gradual relaxation of mobility restrictions and the ongoing vaccination campaign are set to push up private consumption as forced and precautionary savings should gradually subside after a steep rise in the household savings' rate to 12.8% in 2020. The forecast also factors in the expected deployment of the Recovery and Resilience Plan leading to a strong increase in investments, particularly in 2022. In the external sector, both exports and imports are projected to rise at high rates over the forecast period with an overall positive net contribution to growth. However, risks remain tilted to the downside due to Portugal's high reliance on foreign tourism where uncertainty on the recovery path remains high.

Imbalances and their gravity

Portugal´s net international investment position (NIIP) remains well beyond the estimated prudential benchmark. As of the end of 2019, the NIIP stood at -100.5% of GDP, deviating significantly from the estimated prudential and fundamentals-explained thresholds of -52% and -20% of GDP, respectively. Non-defaultable instruments accounted for around half of the NIIP, composed mostly of foreign direct investments (FDI), which partly offset the risks of outflows related to abrupt changes in the external market environment. Nearly 60% of the NIIP stems from government debt, whose structure and market performance has substantially improved over the past years.

Private debt is facing multiple challenges. Consolidated private debt is estimated at 148.8% of GDP as of the end of 2019. Compared to the peak in 2012, the ratio was much closer to the indicative headline threshold of 133%. Yet, the deviation is still large judged by country specific indicators. The ratios of corporate and household debt stood at 85.2% and 63.6% respectively. Both were significantly beyond the estimated country-specific prudential and fundamentals-based benchmarks ([1]). For corporates, these benchmarks were estimated at 63% and 60%, respectively, and for households at 40% and 35%. The legacy of non-performing loans remained an additional weakness in the debt structure, particularly in the corporate sector, but improvements in the functioning of the secondary market for bad assets somewhat mitigated the risks. As regards households, the high level of indebtedness was accompanied by a relatively low saving rate observed before the outbreak of the COVID-19 pandemic.

The public debt-to-GDP ratio was on a steady downward path in the period 2017-2019, but remained high, well above the benchmark of 60%. The public debt-to-GDP ratio declined to 116.8% in 2019, supported by a solid primary surplus, a favourable denominator effect and decreasing interest expenditure. However, the size of previously contracted public contingent liabilities – in particular those related to past bank support measures – remained non-negligible. The latest debt sustainability analysis confirms that the country faces *high* risk in the medium-term. ([2]) At the same time, Portugal’s public debt management strategy contributed to mitigating vulnerabilities by preserving a substantial cash buffer and smoothening the debt redemption profile, including through early repayments of financial assistance loans. ([3]) Market financing conditions remained favourable – backed by a series of rating upgrades – with interest rates hovering around historically low levels and spreads decreasing vis-à-vis European peers.

Low productivity weighs on Portugal’s income convergence. Portugal’s economy grew faster than the EU average in the period 2017-2019 along with a small improvement in the country’s labour productivity vis-à-vis the EU average. In 2019, the country’s income gap vis-à-vis the EU average was estimated at about 20%, measured in purchasing power standards per capita. Despite the improvement over three consecutive years, the gap was still worse than 10 years earlier. Negative factors weighing on Portugal’s productivity include the low, albeit improving, stock of labour skills and capital accumulation. Productivity appears also restrained by the specialisation in low value added sectors and the large share of small firms. Portugal’s share of high technology products in exports was estimated at only 4% in 2018 and was the lowest in the EU, complementing the structural restraints to productivity.

Evolution, prospects and policy responses

The external adjustment is temporarily reversed by the COVID-19 pandemic. After several years of steady improvement, the steep economic contraction driven by the outbreak of the pandemic in early 2020 worsened the NIIP from -100.5% of GDP at the end of 2019 to preliminary estimated -105.4% as of the end of 2020. However, in absolute terms the NIIP improved by EUR 1.9 billion in 2020 despite the large deterioration in tourism inflows. The impact from net external flows was still negative but net external liabilities benefited from significant valuation effects. The latter were largely due to the increase

([1]) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodologies are described in European Commission (2017) and updates to the methodology have been subsequently proposed in European Commission (2018).

([2]) See Article 126(3) report (June 2021) and PPS report (June 2021). The Debt Sustainability Monitor 2020 contains detailed methodological explanations.

([3]) The financial assistance loans to the International Monetary Fund were fully repaid by the end of 2018 and an early first repayment of EUR 2 billion to the European Financial Stability Facility was also carried out in October 2019.

in the monetary gold value and the decrease in domestic stock prices, which reduced the FDI-part of the NIIP as well as liabilities related to portfolio holdings of domestic stocks by non-residents. With the expected economic recovery, the valuation effects have the potential to reverse, while the NIIP ratio would benefit from the expected gradual recovery in tourism and GDP. Nevertheless, the current projections on the external flows point to a substantial slowdown in the pace of adjustment relative to the pre-pandemic trajectory, as foreign tourism is projected to face long-term constraints with a lasting impact on Portugal's large share of tourism-related exports, particularly in the context of the country's large dependence in the aviation sector. The current account moved from a small surplus in 2019 to a deficit of 1.2% of GDP in 2020.

The NIIP ratio is set to resume its positive trajectory. With the expected economic recovery in 2021-2022 and the projected slight improvement in the current account, the NIIP ratio to GDP is set to resume its positive trend. Over the medium term, the country's external position is also expected to benefit from the grants assigned to Portugal under the EU's Recovery and Resilience Facility. Grants under the Recovery and Resilience Facility are estimated to reach around 6% of the country's annual GDP in 2021-2026. On the other hand, the positive valuation effects seen in 2020 have the potential to reverse in the following years that could limit slightly the favourable impact from the favourable projections on GDP and the balance of payments.

In 2020, the policy efforts mostly focussed on temporary measures to address the impact of the pandemic. These included the strengthening of the resources in the short term of the health system, a set of measures to preserve employment (compensations to those affected by temporary layoffs, exemption of social contributions etc.) and support to companies (direct liquidity support, guarantees, tax deferrals, moratoria etc.). The government response also included measures to strengthen institutional resilience (such as measures to ensure the functioning of the justice system remotely).

Some measures have also been taken to address macro-economic imbalances. In the area of business environment, the authorities launched the Programa Internacionalizar 2030, an instrument which establishes the priorities for the internationalization of the economy in the medium term (with a focus on exports and FDI), and a National Promotional Bank (Banco Português de Fomento) was established, aimed at addressing market failures and structural challenges of the low capitalisation of the Portuguese economy. In the area of justice, targeted measures designed to introduce further improvements in disposition of bad assets continue to be implemented, including rapid reaction teams to deal with case backlogs and the establishment of specialized chambers.

Private indebtedness increased in 2020 due mainly to the contraction in GDP. After reaching a peak of 210.6% of GDP at the end of 2012, the ratio of consolidated private debt to GDP had been steadily decreasing to 148.8% of GDP by the end of 2019, correcting a substantial part of the deviation from the indicative threshold of 133%. However, the outbreak of the COVID-19 pandemic in early 2020 temporarily broke the favourable trend, as the ratio is estimated to have increased by around 12 percentage points last year due mainly to the contraction in GDP. On the positive side, both households' and corporates' deposits increased providing the private sector with a liquidity buffer to face potential financial problems. However, these dynamics in aggregate terms might be hiding solvency problems in individual firms, particularly those in sectors severely hit by the pandemic. Nevertheless, the outlook for the private debt ratio appears favourable, driven mainly by the positive denominator impact of the economic growth projected for 2021 and 2022.

The banking sector remains resilient but challenges lie ahead. The Portuguese banking system is more resilient now than at the outset of the global financial crisis a decade ago, but there are also new vulnerabilities. The banking system's Core Equity Tier 1 (CET1) capital ratio stood at 14.6% in Q2-2020. While this is below the European average, it comes after a steady increase in capital ratios, most recently also reflecting the impact of state guarantees, which reduced risk weighted assets and retained earnings. At the crisis' onset, supervisors relaxed several capital requirements allowing banks to manage their equity in a flexible way during the pandemic. Furthermore, policy measures such as loan moratoria softened the initial impact of the pandemic on the financial system and contributed to a further decrease in NPLs. As of September 2020, the NPL ratio dropped to 5.3% relative to 6.2% at the end of 2019. However, the ultimate economic impact of the pandemic on NPLs will only become visible with a delay, in particular once moratoria expire.

The steady decrease of the public debt-to-GDP ratio came to a halt in 2020. In view of the COVID-19 crisis, the primary deficit – reflecting the operation of automatic stabilisers and fiscal policy support – and the unfavourable snowball effect – whereby the negative denominator effect stemming from the contraction in GDP added to the interest burden – drove the public debt-to-GDP ratio upwards to a peak of 133.6% in 2020. At the same time, the substantial increase of the cash buffer by 4.7% of GDP (to 8.5% of GDP), according to data of the Treasury, was also underlying the increase of the public debt-to-GDP ratio in 2020. Looking ahead, the public debt-to-GDP ratio is projected to resume a downward path over the forecast horizon, declining to 127.2% in 2021 and to 122.3% in 2022, as the economic recovery gains momentum and the crisis mitigation measures are gradually phased out. In addition, Portugal has continued to deploy efforts to reduce interest expenditure and contain annual peaks in the debt redemption profile. The supplementary financing needs triggered by the crisis response have also been eased by the assistance provided under the European instrument for Support to mitigate Unemployment Risks in an Emergency (SURE), especially in relation to the sudden and severe increase in public spending on short-time work schemes and similar measures, as well as health-related measures related to the COVID-19 outbreak.

Labour productivity moves sideways during the pandemic. While employment proved more resilient to the economic shock than expected, helped by government support schemes, productivity in terms of per capita output dropped dramatically in 2020 as GDP contracted much faster than employment. On the other hand, productivity in terms of output per hour worked improved as furloughs and reduced worktime during lockdowns reduced substantially the total number of hours worked. Similar developments took place in the main trading partners and in relative terms labour costs and competitiveness indicators do not cause immediate concerns. Total factor productivity remained relatively stable but the steep drop in equipment investment, from an already low pre-crisis base, is posing further challenges to the country's medium-term outlook on productivity and competitiveness. Despite this drop, total investment remained the most resilient expenditure component of GDP due to the strong performance of the construction sector. Therefore, Portugal's capital formation faced a significantly smaller contraction during the pandemic relative to trading partners. The expected economic recovery is set to improve the country's productivity as GDP is forecast to grow faster than employment in 2021-2022. Potential growth is also projected to recover to its pre-crisis level until 2022. This is mainly due to the expected increase in the investment ratio as a result of the financing envisaged under the Recovery and Resilience Facility (RRF). Total factor productivity is projected to have a broadly stable contribution to potential growth over the forecast period. Nevertheless, policy efforts for boosting productivity, particularly labour skills, remain essential for improving Portugal's competitiveness and potential growth and to accelerate the pace of external rebalancing.

House price growth moderates. Against the backdrop of the adverse economic shock in 2020, the growth in real house prices moderated to 7.4% in 2020, slowing from 8.6% in 2019. The calculations for 2019 show that prices were already above the long-term average and the valuation gap widened. However, the price to income gap was only slightly positive. The economic shock also affected rental prices, which decreased during the initial period of mobility restrictions. More substantial corrections were observed in areas with strong tourism activities. This correction in rents had a favourable impact on housing affordability, which had deteriorated substantially in the previous years. However, on full-year basis rental prices also retained a positive growth rate of 2.6% in 2020, slowing from 3.2% in 2019. In the light of low mortgage loans and increasing deposits, house prices are expected to grow at a relatively high rate in the medium term but the expected slow recovery in tourism will likely offset part of the demand, particularly for housing properties with potential for commercialised tourism-related services. Overall, the increase in house prices continues to be seen as a correction from previously low levels of valuation and is currently not considered an imbalance, but warrants close monitoring.

Overall assessment

After significant progress in reducing its imbalances in previous years, debt ratios increased with the economic contraction triggered by the COVID-19 pandemic. Despite this progress, the country's indebtedness had remained well beyond benchmarks and the outbreak of the crisis has further worsened the country's position, primarily through the GDP decline of 7.6% in 2020. The overall negative effect was more pronounced for public debt where the drop in tax revenues and additional spending in support of jobs and incomes entailed larger financing needs. The ratios of private debt and external liabilities were affected mostly through the denominator effect of GDP. With the expected economic recovery, Portugal's debt ratios are set to move back on a downward path but for some indicators, particularly public debt, it will take several years to return to the pre-crisis level. The country's large exposure to foreign tourism is weighing negatively on the external sector but the expected RRF grants would support the NIIP position in the medium term.

Policy measures re-focused towards recovery challenges. Overall, progress has been made to focus economic policy related to investment in the area of clean and efficient production and use of energy, while progress has been more limited in the area of research and innovation and for transport. In the area of education, incremental steps are made to increase digital education and training for all, while efforts are being taken to improve the digitalisation of businesses. However, there is still available scope to improve the quality of public finances, by prioritising growth-enhancing spending, strengthening expenditure control and efficiency, as well as addressing vulnerabilities in the financial sustainability of the National Health Service and state-owned enterprises. Weaknesses in the business environment persist, in particular related to regulatory restrictions in regulated professions and to sector-specific regulatory and administrative burden for firms. Despite progress, in the area of justice, Portugal remains among the EU countries with the lengthiest administrative and tax proceedings and displaying one of the highest rates of pending administrative cases. Time lags are still very high and continue to impact negatively the secondary market for non-performing loans.

Table 1.1: **Assessment of Macroeconomic Imbalances Matrix - Portugal**

	Gravity of the challenge	Evolution and prospects	Policy response
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
External balance	The net international investment position (NIIP) stood at -100.5% of GDP at the end of 2019, standing well beyond the prudential threshold of -52%. However, risks are partly offset by the fact that nearly half of the NIIP is composed of non-defaultable instruments and the lower risk-premium assigned to Portugal over the past years. The current account was slightly positive in 2019 and broadly in line with the CA norm but well beyond the estimated surplus of 1.6% of GDP per year that is required to reach the country specific prudential NIIP benchmark over a 10-year period. This points out to further adjustment needs in order to reduce risks to the economy.	Portugal's NIIP improved from its lowest level of -123.8% of GDP at the end of 2014 to -100.5% at the end of 2019. However, the shock caused by COVID-19 brought a deterioration to -105.4% by the end of 2020 but the positive trend is expected to resume in 2021 helped by the gradual recovery in tourism. In the medium term, the NIIP is also expected to benefit from the RRF grants earmarked to Portugal. The current account balance deteriorated from a small surplus in 2019 to -1.2% of GDP in 2020 and is set improve only marginally by 2022. Unit labour costs are increasing at a rate similar to Portugal's main trading partners. While the market shares of exports have recently increased, their medium-term growth is predicted to deteriorate in the light of the expected protracted recovery in tourism.	Progress has been made over the past years with tackling rigidities in product and labour markets. However, further measures to boost productivity and improve competitiveness remain essential to achieve a more significant improvement in the external balance. There is a risk that the impact of COVID-19 and the measures taken to protect jobs and incomes could further push up unit labour costs, slowing the export-led recovery. Such developments are expected in the main trading partners as well. However, Portugal may be more vulnerable due to its high exposure to foreign tourism where demand constraints are expected in the short- to medium-term forecast period. It is therefore essential to find the right balance of policy measures to ensure income growth on the one hand and competitiveness on the other.
Private debt	High private-sector debt is still weighing negatively on investment and growth. Private debt is estimated at 149% of GDP at the end of 2019, which is still significantly above the estimated country-specific fundamentals and prudential benchmarks, for both households and non-financial corporations. The high stock of non-performing loans remains a challenge. While it has been declining, the NPLs ratio remains high.	Consolidated private debt fell from a peak of 211% of GDP at end-2012 to 149% at end-2019 but the ratio deteriorated substantially in 2020 due mainly to the drop in GDP. The outlook however remains favourable. The process of deleveraging is set to continue, mainly reflecting nominal growth in GDP amid a broadly stable stock of credit. Both the corporate and household sectors are expected to contribute to the deleveraging process. NPLs continued to decline in 2020 despite the economic challenges lined to the pandemic. However, the high level of NPLs still poses a risk to financial stability and impedes the effective allocation of credits. The magnitude of these risks will only become clear once the moratoria expire.	A three-pillar strategy designed to reduce non-performing loans is being implemented since 2017. The strategy includes specific reduction targets, which the banks with the largest non-performing loans ratios are to meet. Debt moratoria have been introduced since March 2020 in response to the economic shock brought by the COVID-19 pandemic. The moratoria are estimated to have covered over 20% of the loans are set to expire in September 2021. This is posing policy challenges for the phase-out of the moratoria when NPL stocks may rise.
Public debt	The public debt-to-GDP ratio declined to 116.8% at the end of 2019. The high public debt-to-GDP ratio makes Portugal particularly vulnerable to changes in economic and financing conditions, which translate into high debt sustainability risks in the medium term.	After hovering around 130% between 2014 and 2016, the public debt-to-GDP ratio was steadily decreasing afterwards up until the COVID-19 outbreak in 2020, having bottomed at 116.8% at the end of 2019. After the surge to 133.6% in 2020, the public debt-to-GDP ratio is projected to start decreasing again as of 2021. Meanwhile, the general government	Key fiscal-structural reforms could have been implemented more decisively to strengthen Portugal's fiscal sustainability even further. Some measures were taken in past years in the areas of tax reforms, tax compliance, expenditure control, pensions, healthcare, state-owned enterprises and public administration. However, policy gaps persist, notably related to the

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		balance moved from a small surplus in 2019 to a deficit of 5.7% of GDP in 2020. The deficit is projected to start decreasing as of 2021. Without additional growth-friendly fiscal consolidation compared with the Commission's no-policy-change baseline scenario, the public debt-to-GDP ratio would still remain significantly above the Treaty reference value of 60% by 2031.	long-delayed implementation of the 2015 Budgetary Framework Law, which would be instrumental to improve the quality of public finances and contain structural upward pressures on public expenditure. In addition, more substantial progress is needed to strengthen the sustainability and resilience of the National Health Service and enhance the financial performance of state-owned enterprises.
Productivity	Low productivity growth hinders competitiveness and potential growth. This limits the prospects for resuming private and public deleveraging from the debt levels further hiked by the crisis, a more sustainable and inclusive growth, and progress in income convergence.	Labour productivity has improved marginally from 2017 until 2019 due to the decline in labour market slack and a slowdown in employment growth. However, productivity in terms of per capital output dropped dramatically in 2020 as GDP contracted much faster than employment. Productivity remains impaired by low investment levels, skill gaps, rigidities in product and labour markets, and weaknesses in the business environment and the judiciary.	There are a number of measures designed to help raise productivity and competitiveness, including policies in the areas of research and innovation, competition in services, and transport infrastructure. Other measures that could help to boost productivity and external competitiveness have to do with the business environment, and the efficiency of the justice system.

Main takeaways

- Despite the progress achieved in the past years, prior to the COVID-19 pandemic, the Portuguese economy continues to be marked by a large stock of external, public and private debt, as well as by a high share of non-performing loans. In addition, productivity growth is low, hampering the deleveraging process. While the current account balance helped improve the net international investment position (NIIP) up to 2018, it turned negative in 2019 and is expected to deteriorate further.

- Both private and public debt has declined by the end of 2019, mostly as a result of nominal GDP growth. Although the situation reversed abruptly in 2020 with the outbreak of COVID-19, the expected economic recovery as of 2021 is set to turn the debt ratios back on a declining track even if from elevated levels. Despite the projected downward path, the public debt-to-GDP ratio is set to remain at a very high level and weighs on the stock of external liabilities. Portugal's NIIP remains a significant source of vulnerability, as the recent reversal of the current account risks bringing adjustment to a standstill. On the other hand, the structure of external liabilities improved in recent years due to a shift from debt to foreign direct investment and a lower risk profile of domestic debtors. The high stock of NPLs also remains a key weakness. The adjustment is advancing, despite the COVID-19 shock, but the real impact of the crisis on the credit quality and NPLs will become clear once the moratoria on loan repayments expire.

- Policy progress has been made to focus economic policy on repairing the damages caused by the COVID-19 crisis. In the area of education, incremental steps are being taken in order to increase digital education and training for all, while efforts are being taken to improve the digitalisation of businesses. At the same time, decisive policy action is needed to strengthen the sustainability and resilience of the National Health Service, mitigate vulnerabilities in some state-owned enterprises, and improve the quality and composition of public finances. Weaknesses in the business environment persist, in particular related to regulatory restrictions in regulated professions and to sector-specific regulatory and administrative burden for firms. Despite progress, in the area of justice, Portugal remains among the EU countries with the lengthiest administrative and tax proceedings and displaying one of the highest rates of pending administrative cases. Time lags are still very high and continue to impact negatively the secondary market for non-performing loans.

Source: European Commission Services

Table 1.2: **Selected economic and financial indicators, Portugal**

	2004-07	2008-12	2013-18	2019	2020	forecast 2021	forecast 2022
Real GDP (y-o-y)	1.7	-1.4	1.0	2.5	-7.6	3.9	5.1
Potential growth (y-o-y)	1.0	-0.4	0.4	1.8	0.9	1.8	1.3
Private consumption (y-o-y)	2.0	-1.6	1.8	2.6	-5.9	4.0	3.8
Public consumption (y-o-y)	1.4	-1.1	-0.3	0.7	0.4	2.0	1.7
Gross fixed capital formation (y-o-y)	0.6	-7.7	3.8	5.4	-1.9	4.6	6.9
Exports of goods and services (y-o-y)	5.6	1.5	5.8	3.9	-18.6	10.3	8.9
Imports of goods and services (y-o-y)	5.7	-2.6	6.4	4.7	-12.0	9.5	6.0
Contribution to GDP growth:							
Domestic demand (y-o-y)	1.8	-2.8	1.0	2.7	-4.1	3.8	4.1
Inventories (y-o-y)	0.3	-0.1	0.1	0.1	-0.6	0.0	0.0
Net exports (y-o-y)	-0.4	1.5	-0.1	-0.3	-2.9	0.1	1.0
Contribution to potential GDP growth:							
Total Labour (hours) (y-o-y)	-0.3	-1.2	0.2	0.9	0.3	0.9	0.3
Capital accumulation (y-o-y)	0.8	0.3	-0.1	0.1	-0.1	0.1	0.2
Total factor productivity (y-o-y)	0.4	0.5	0.3	0.9	0.7	0.9	0.8
Output gap	-0.1	-1.2	-1.1	3.5	-5.6	-3.3	-0.2
Unemployment rate	7.6	11.4	11.7	6.5	6.9	6.8	6.5
GDP deflator (y-o-y)	3.0	0.6	1.7	1.7	2.4	1.4	1.5
Harmonised index of consumer prices (HICP, y-o-y)	2.5	1.9	0.5	0.3	-0.1	0.9	1.1
Nominal compensation per employee (y-o-y)	3.3	0.4	1.3	3.5	2.9	2.8	2.8
Labour productivity (real, person employed, y-o-y)	1.8	0.6	0.3	1.7	-5.9	.	.
Unit labour costs (ULC, whole economy, y-o-y)	1.4	-0.2	1.1	1.8	9.3	-0.1	-1.0
Real unit labour costs (y-o-y)	-1.5	-0.8	-0.6	0.0	6.8	-1.5	-2.5
Real effective exchange rate (ULC, y-o-y)	0.0	-2.0	0.5	-1.3	.	.	.
Real effective exchange rate (HICP, y-o-y)	0.4	-0.8	0.0	-1.8	0.9	-0.2	-0.6
Net savings rate of households (net saving as percentage of net disposable income)	1.8	1.5	-1.1	-2.1	4.1	.	.
Private credit flow, consolidated (% of GDP)	13.8	4.4	-1.4	2.3	4.2	.	.
Private sector debt, consolidated (% of GDP)	173.6	203.4	177.5	149.5	161.2	.	.
of which household debt, consolidated (% of GDP)	81.5	90.6	75.8	63.7	68.3	.	.
of which non-financial corporate debt, consolidated (% of GDP)	92.1	112.8	101.6	85.8	92.9	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	1.2	4.1	10.0	4.9	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-4.5	-1.7	3.1	-0.6	-0.1	3.2	3.7
Corporations, gross operating surplus (% of GDP)	19.8	20.9	21.8	21.3	19.5	22.6	22.9
Households, net lending (+) or net borrowing (-) (% of GDP)	1.3	3.0	2.6	1.5	5.9	2.1	0.8
Deflated house price index (y-o-y)	-1.6	-2.9	6.9	8.6	7.4	.	.
Residential investment (% of GDP)	5.7	3.7	2.7	3.2	3.5	.	.
Current account balance (% of GDP), balance of payments	-9.4	-8.0	0.9	0.4	-1.2	-0.6	-0.1
Trade balance (% of GDP), balance of payments	-7.8	-5.4	1.2	0.7	-1.8	.	.
Terms of trade of goods and services (y-o-y)	-0.1	0.0	0.2	0.6	1.7	-0.8	0.2
Capital account balance (% of GDP)	1.4	1.5	1.2	0.8	1.3	.	.
Net international investment position (% of GDP)	-77.1	-107.8	-115.2	-100.5	-105.4	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (1)	-44.3	-71.3	-67.4	-47.0	-47.1	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	175.7	213.4	192.5	170.7	181.8	.	.
Export performance vs. advanced countries (% change over 5 years)	6.6	-3.5	2.8	6.7	4.3	.	.
Export market share, goods and services (y-o-y)	-2.4	-3.7	2.0	0.8	-9.4	2.2	3.4
Net FDI flows (% of GDP)	0.6	-2.4	-3.5	-3.6	-1.7	.	.
General government balance (% of GDP)	-4.8	-7.8	-3.9	0.1	-5.7	-4.7	-3.4
Structural budget balance (% of GDP)	.	.	-1.8	-1.2	-2.0	-3.2	-3.2
General government gross debt (% of GDP)	71.4	101.4	128.0	116.8	133.6	127.2	122.3
Tax-to-GDP ratio (%) (3)	34.4	34.3	36.9	36.7	37.1	36.1	35.5
Tax rate for a single person earning the average wage (%) (4)	22.4	22.3	27.2	27.3	27.4	.	.
Tax rate for a single person earning 50% of the average wage (%) (4)	13.9	11.5	11.0	11.0	11.0	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
(4) Defined as the income tax on gross wage earnings plus the employee's social security contributions less universal cash benefits, expressed as a percentage of gross wage earnings
Source: Eurostat and ECB as of 2021-05-05, where available; European Commission for forecast figures (Spring forecast 2021)

2. THEMATIC ISSUE: EXTERNAL BALANCE

Situation entering the COVID-19 crisis

Portugal's external position had undergone a significant adjustment for several years prior to the COVID-19 pandemic. The current-account deficits in the tune of about 10% of GDP until 2010 had started to decline driven by a sharp contraction of aggregate demand (Graph 2.1(a)), i.e. gradual improvements in government's and corporates' net borrowing position (Graph 2.1(b)). From 2013 the current account had moved to a small surplus that was maintained until 2019. The capital account surplus contributed to economy's positive net lending (Table 2.2).While the balance of trade with goods had moved sideways over the past years, the strong growth in Portugal's tourism sector played a key role in the external adjustment (Graph 2.1(c)). Net inflows from foreign tourism increased from 2.6% of GDP in 2010 to 6.1% of GDP in 2019. Accordingly, the net international investment position (NIIP) improved from its lowest level of -123.8% at the end of 2014 to -100.5% of GDP as of the end of 2019. The structure of the NIIP had also improved in the light of increased share of non-defaultable instruments, primarily FDI, and improved parameters of the public debt accounting for a large proportion of the net stock of external liabilities (Graphs 2.1(e) and 2.1(f)). Nevertheless, as of the end of 2019, the NIIP stood well beyond the estimated prudential and fundamentally-explained thresholds of -52% and -20% of GDP (Table 2.2), respectively, and remained one of the most negative in the EU. The current account balance was significantly better than the estimated value required to stabilise the NIIP but at the same time well below the value required to reach the prudential NIIP target over a 10-year period.

Current account developments and outlook

The outbreak of the COVID-19 pandemic in early 2020 strongly impacted the country's trade flows. The shock was particularly damaging for the tourism sector, whose negative impact on the current account was only partly offset by other items, as the country's output was more significantly affected than aggregate demand (Graph 2.1(a)). While the government's net lending deteriorated substantially related to fiscal support measures, its impact on the total economy's net lending was mainly cushioned by increased saving surplus of the household sector (Graph 2.1(b)). Overall, the current account moved to a deficit of 1.2% of GDP in 2020 with abrupt sideway movements in most of its components. The surplus in trade with services contracted from 8.3% of GDP in 2019 to 4.2% in 2020, reflecting the huge drop in travel receipts. In net terms, travel receipts declined by EUR 5.0 billion (2.5% of GDP) in 2020 and a further drop of EUR 1.9 billion (0.9% of GDP) was recorded in net transport receipts where most of the impact was driven by the drop in airline passengers. Reduced deficits in trade with goods and primary income offset about 60% of the negative impact from the balance of services while the balance in secondary income, including migrant remittances, remained broadly stable. The balance of goods benefited from the positive terms of trade, due to the drop in crude oil prices, and the steep decline in imports of investment goods. The breakdown of trade with goods by main categories shows that the balance in consumer goods also improved although much less than the one for investment goods. The improvement in the net primary income was largely due to lower dividend payments to non-residents.

Productivity dropped substantially in 2020 in terms of output per employee. Helped by government measures in support of jobs and incomes, employment dropped at a much lesser pace than GDP in 2020, bringing the productivity in terms of output per employee down by around 6%. However, a substantial drop in hours worked, reflecting the large impact of furloughs and reduced workload during the lockdowns, moved productivity upwards by around 1.5% in terms of output per hour worked. At the same time, unit labour costs increased substantially by 9.3% in 2020, accelerating from 1.8% in the previous year. While these changes were technically unfavourable for the country's competitiveness, the figures mirror a similar temporary shock across all main trading partners of Portugal. Therefore, in relative terms Portugal's competiveness was not significantly affected. The trade figures show that the country's export market share in goods relative to the demand in the main trading partners improved marginally in 2020. This share, however, deteriorated significantly for exports of services where the country's large exposure to tourism brought an asymmetric correction relative to trading partners with lower exposure to tourism.

As regards the main factors of production, Portugal's capital base was less affected in comparison with its trading partners. Investment, excluding inventories, dropped by only 1.9% in 2020 due to the resilience of the construction sector, which retained an upward trend during the COVID-19 pandemic. Total factor productivity is also estimated to have remained stable. Nevertheless, the steep drop in equipment investment, from an already low pre-crisis base, was not supportive to structural improvements in Portugal's exports. As of 2018, the share of high technology products in Portugal's exports remained the lowest in the EU at 4%.

The current account is projected to improve slightly in the short run despite scarring effects in tourism. With the expected gradual recovery in tourism, the current-account balance is projected to improve slightly in 2021-2022 though it is likely to remain in a small deficit and slightly worse than the estimated current account explained by fundamentals (Table 2.2). This is due to the expectations that the tourism sector is facing scarring effects, both on the supply and demand side, and would not be able to reach its pre-pandemic level before the end of 2022. Nevertheless, the current account is projected to remain significantly better than the estimated balance of -4.4% needed to stabilise the NIIP at the current level (table 2.1). On the other hand, the projections also show that the current account would be well below the surplus of 1.9% of GDP needed to reach in 10 years the estimated NIIP country specific prudential benchmark of around -50% of GDP.

NIIP developments and outlook

Net external liabilities declined in absolute terms in 2020 but their ratio to GDP worsened. Despite the deterioration in the current account, the overall balance in the current and capital accounts remained slightly positive and together with positive valuation effects contributed to a small improvement in the NIIP position in absolute terms. However, against the backdrop of the significant economic contraction, the ratio of the NIIP to GDP deteriorated from -100.5% at the end of 2019 to -105.4% as of the end of 2020. On the account of positive price valuations, the NIIP benefited from the market fluctuations in the monetary gold value and the decrease in domestic stock prices, which reduced the FDI-part of the NIIP as well as liabilities related to portfolio holdings of domestic stocks. The net inflow of FDI meanwhile dropped significantly in 2020 (Graph 2.1(d)) against the backdrop of unprecedented global market destructions and uncertainties. Nevertheless, the share of non-defaultable instruments, composed mostly of FDI, is estimated to have remained relatively stable at around 50% of the NIIP.

The current account is expected to improve somewhat in the short term, driven by a gradual recovery in tourism, but is nevertheless set to remain on a negative territory. On the other hand, the country's external position, and particularly the capital account, is expected benefit from the grants expected to be disbursed under the Recovery and Resilience Facility in the period of 2021-2026 that would help reduce the net stock of external liabilities. Overall, the current projections on the combined impact of the current and capital accounts suggests that the NIIP would improve marginally in absolute terms (until 2022) and the ratio to GDP would be also benefiting from the expected economic growth. Nevertheless, the expected current account balance is estimated well below the value required to reach the prudential NIIP target over a 10-year period although it is still significantly better than the value required to stabilise the NIIP at the current level (Table 2.1).

Table 2.1: **Sensitivity analysis current account balance and net international investment position**

	Low nominal GDP growth (2% avg 2021-30)	Baseline scenario (3% avg 2021-30)	High nominal GDP growth (4% avg 2021-30)
NIIP stabilisation	-3.4	-4.4	-5.4
NIIP at -70% of GDP	0.5	-0.4	-1.2
NIIP at -50% of GDP	2.6	1.9	1.1
NIIP at -35% of GDP	4.3	3.6	2.9

(1) The table above shows the annual average current account balance required to reach a certain NIIP by 2030, based on different assumptions for GDP growth, assuming no NIIP valuation effects and a stable capital account set at its median forecast over 2020-22 (1.3% of GDP). See also European Commission, 2015, 'Refining methodology for NIIP-based current account benchmarks', LIME Working Group 17 June 2015.
Source: European Commission calculations

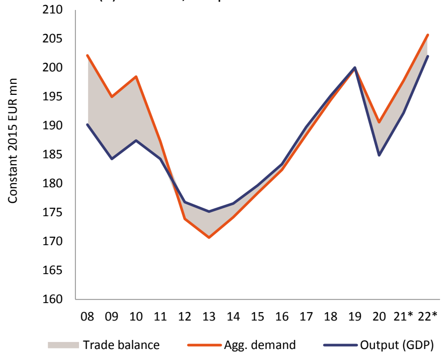
Table 2.1: **Selected external sector indicators, Portugal**

		2003-07	2008-12	2013-17	2018	2019	2020	2021f	2022f
Flows [1]	*Source:*								
CA balance as % of GDP, NA	*(b)*	**-8.9**	**-7.8**	**0.5**	**0.3**	**0.2**	**-1.1**	**-0.8**	**-0.4**
CA balance as % of GDP, BoP	*(a)*	-8.8	-8.0	0.9	0.6	0.4	-1.2	-0.9	-0.5
Cyclically adj. CA balance as % of GDP [2]	*(c)*	-9.6	-7.7	0.2	1.2	1.6	-0.9	-1.1	-0.3
CA req. to stabilize NIIP above -35% [3]	*(c)*	-0.5	0.6	0.0	0.1	-0.2	-0.3	-0.8	-0.8
CA explained by fundamentals (CA norm) [4]	*(c)*	-1.8	-1.0	-0.3	0.0	0.1	0.2	0.1	0.3
Required CA for specific NIIP target [5]	*(c)*	0.1	2.4	2.7	2.1	1.6	1.5	1.1	1.3
Trade bal. G&S, % of GDP, NA	*(b)*	-7.7	-5.8	0.8	0.5	0.4	-2.0	-2.1	-1.0
Required TB for specific NIIP target [5]	*(c)*	1.0	4.8	1.3	0.8	0.6	0.6	0.7	0.7
Stocks									
NENDI as % of GDP	*(a)*	**-41**	**-71**	**-70**	**-55**	**-47**	**-47**		
of which: net portfolio debt	*(a)*	-4	-18	-9	0	1	2		
of which: net mutual fund shares	*(a)*	4	5	9	10	13	14		
of which: net other investment	*(a)*	-47	-65	-79	-76	-70	-74		
NIIP as % of GDP	*(a)*	**-74**	**-108**	**-117**	**-106**	**-100**	**-105**	**-101**	**-94**
Prudential NIIP/NENDI benchmark	*(c)*	-53	-52	-50	-52	-52	-50	-51	-52
Fundamentally expl. NIIP benchmark (NIIP norm)	*(c)*	-15	-19	-23	-20	-20	-21	-18	-17
Gen. Government NIIP	*(a)*	-42	-57	-77	-59	-58	-64		
Private Sector NIIP	*(a)*	-14	-20	-36	-44	-48	-53		
of which: Net FDI [6]	*(a)*	-10	-16	-28	-32	-34	-38		
MFI (excl CB) NIIP	*(a)*	-43	-31	-8	-9	-7	-2		
Oth. financials NIIP	*(a)*	15	3	6	7	13	15		
Central bank NIIP	*(a)*	10	-3	-2	-2	0	-2		
of which: Reserves	*(a)*	5	8	10	11	10	12		
of which: Target2	*(a)*		-26	-36	-40	-36	-40		
Value-added trade and capital account									
VA imports % of agg. demand [7]	*(d)*	29	29	30					
Capital account bal. as % of GDP, NA	*(b)*	1.5	1.4	1.2	1.0	0.8	1.2	1.3	1.5
Indicators in % of potential GDP									
CA balance as % of potential GDP, NA	*(b,c)*	-8.9	-7.8	0.5	0.3	0.2	-1.0	-0.8	-0.4
CA balance as % of potential GDP, BoP	*(a,c)*	-8.8	-8.0	0.9	0.6	0.4	-1.1	-0.9	-0.5
Cyclically adj. CA balance as % of potential GDP	*(c)*	-9.6	-7.6	0.2	1.2	1.6	-0.8	-1.0	-0.3
Trade bal. G&S, as % of potential GDP, NA	*(b,c)*	-7.7	-5.7	0.8	0.5	0.4	-1.9	-2.0	-1.0
NENDI as % of potential GDP	*(a,c)*	-41	-70	-69	-57	-49	-44		
NIIP as % of potential GDP	*(a,c)*	-74	-106	-114	-109	-104	-99	-97	-94
Capital account bal. as % of potential GDP, NA	*(b,c)*	1.5	1.4	1.2	1.0	0.8	1.1	1.3	1.5

(1) Abbreviations: NA=National Accounts, BoP=Balance of Payments, CA=Current Account, NENDI= NIIP excluding non-defaultable instruments, VA= Value Added, TB= Trade Balance.
(1) Flow data refer to national account concept, unless indicated otherwise.
(3) The average CA needed in order to stabilise the NIIP is based on T+10 Ecfin projections.
(4) The CA explained by fundamentals refers to the expected CA given the level of its fundamentals with respect to world average.
(5) The CA or TB needed either to halve the distance to fund. NIIP benchmark, or to reach the prud. NIIP benchmark in 10Y, whichever is higher. Based on T+10 Ecfin projections.
(6) In case private-sector FDI is not available, total economy FDI is displayed.
(7) VA imports as % of aggregate demand describes the % of aggregate demand that is sourced from foreign value added.
(8) More information on benchmark indicators methodology can be found on B1 intranet.
Sources: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) WIOD database.

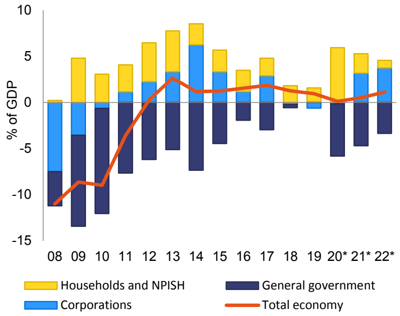
Graph 2.1: **Thematic Graphs: External balance**

(a) Demand, Output and Trade Balance



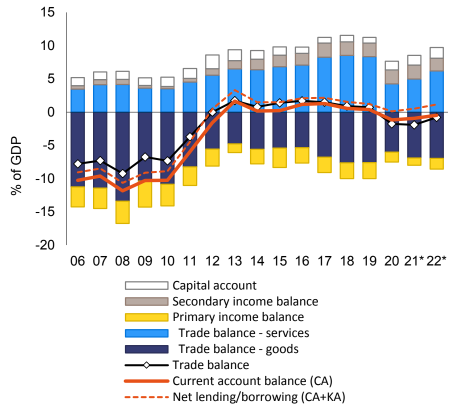
Source: Ameco

(b) Net lending/borrowing by sector



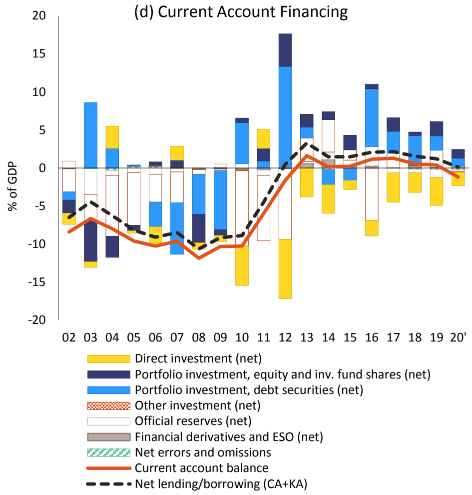
Source: Ameco

(c) Current Account Decomposition



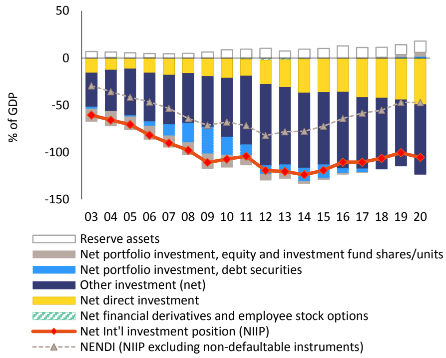
Source: Eurostat, AMECO, ECFIN calculations.
Note: forecast period uses the NA-based figures adjusted for statistical discrepancies (between NA and BoP data) observed in the last available year of data. Services balance includes travel for the forecast period

(d) Current Account Financing



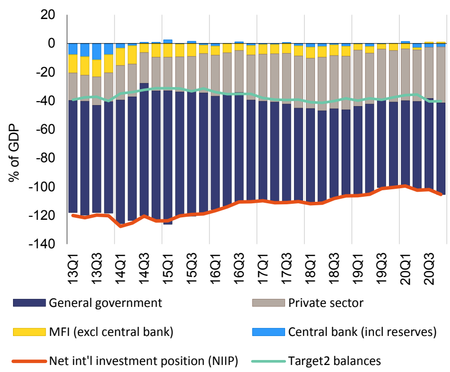
Source: Eurostat

(e) Decomposition of NIIP by instrument



Source: Eurostat

(f) Decomposition of NIIP by sector



Source: Eurostat

Source: European Commission Services

3. THEMATIC ISSUE: PRIVATE DEBT

Situation entering the COVID-19 crisis

Portugal faced the outbreak of the COVID-19 pandemic in early 2020 with high but steadily declining private debt ratios (Table 3.1). Consolidated private debt reached 149% of GDP as of the end of 2019 and the deviation from the indicative threshold of 133% had been substantially reduced from the peak of 210.6% of GDP at the end of 2012. However, private indebtedness continued to exceed significantly the estimated country specific benchmarks (Graph 3.1(b)). The ratios of non-financial corporations (NFCs) and household debt stood at 85.2% and 63.6% respectively. Both were significantly beyond the estimated country-specific prudential and fundamentals-based benchmarks ([4]). For NFCs, these benchmarks were estimated at 63% and 60%, respectively, and for households at 40% and 35%. The legacy of non-performing loans remains an additional vulnerability, particularly in the non-financial corporate sector, as it hampers the ability of the financial sector to extend further credit.

Developments and outlook

The economic contraction in 2020 increased the private debt ratio by around 12 percentage points due mainly to the GDP denominator effect. On the positive side, both households' and corporates' deposits increased, providing the private sector with a liquidity buffer to face potential financial problems. However, these dynamics in aggregate terms might be hiding solvency problems in individual firms, particularly those in sectors severely hit by the COVID-19 pandemic. Nevertheless, the outlook for the private debt ratio appears favourable, driven mainly by the positive denominator impact of the economic growth projected for 2021 and 2022.

The NPL ratio continued to decline, albeit at a slower pace. In Q3 2020, the NPL ratio narrowed by 0.2 pps., to 5.3%, reflecting a decline in NPLs (-4.9%) which exceeded that of total loans in the denominator (1.0%). The NPL ratio of NFCs stood at 10.6% (-0.6 pps.) and the one of households at 3.5% (0.2 pps.). The decline in both ratios resulted from a decrease in the numerator (NPLs). However, when the credit moratoria expire, there may be a sharp increase in NPLs and institutions will have to adapt to more demanding NPL sales market conditions, reflecting the effect of the COVID-19 crisis on the value of assets and recovery processes.

Corporate debt

Non-financial corporate indebtedness increased in 2020, breaking the downward trend observed since 2013. NFCs' indebtedness ratio increased by 7.0 pps. between December 2019 and September 2020, reaching 92.4% of GDP. Both, the increase in NFCs' total debt and the drop of nominal GDP contributed to this change, with the increase in corporate debt mainly due to a respite on loan repayments. High corporate indebtedness is a vulnerability that may result in pressures on corporate solvency. The increase in liquidity and maturities resulting from the State-guaranteed loans, the low interest rates and the extension of credit moratoria have so far mitigated default and insolvencies. Notwithstanding efforts made to avoid a wave of insolvencies, corporate bankruptcies are forecast to increase in 2021. The issue of lengthy judicial proceedings (both civil as well as bankruptcy or corporate recovery cases) often dominated by cases lasting over 5 years, the lack of specialised judges in various courts and levels of judicial proceedings still remains and needs to be addressed. To this end, the Portuguese authorities established in mid-2020 the extraordinary procedure PEVE (Processo Extraordinário de Viabilização de Empresas). PEVE aims for a simple, fast-track court ratification of a restructuring agreement reached

([4]) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodologies are described in European Commission (2017) and updates to the methodology have been subsequently proposed in European Commission (2018).

extra judicially between a company and its creditors. PEVE was implemented to enable companies to respond more efficiently to the COVID-19 pandemic and is planned to last until end-2021.

The share of credit under moratoria and new government-guaranteed loans in total NFCs' loans is significant. At the end of September 2020, 32% of NFCs' stock of loans (EUR 24.4 billion) were under moratoria, a share significantly higher than the EU aggregate (around 9% in June 2020 – latest available data). Furthermore, around 40% of new loans taken out by NFCs between March and September 2020 were associated with State-guaranteed loans. SMEs made more use of State-guaranteed loans than large enterprises (44% vs. 17% of total new loans). Up to September 2020 the State guarantee covered approximately 15% of the total stock of loans to NFCs. According to BdP's Bank Lending Survey of October 2020, demand by firms for loans was mainly driven by financial needs related to inventories and working capital.

There are some signs of an increase in the risks associated with loans to NFCs. The State-guaranteed loans allowed firms to obtain liquidity at more favourable interest rates (1.2% for State-guaranteed loans against 2.4% for loans with no government-backing) and with longer maturity (grace periods of up to 18 months and maximum maturity of 6 years). The large weight of new state-guaranteed loans taken out with maximum maturity, which accounted for approximately one-third of all new loans to firms over this period, allows for a protracted loan repayment profile, which is key to the resilience of firms, in particular for SMEs and firms from sectors of activity most affected by the COVID-19 pandemic. However, the NPL ratio's downtrend noticeably slowed down in the second half of 2020 (Graph 3.1(d)) and stage 2 loans augmented from 9.4% of total loans to 10.6% during 2020.

The effect of the COVID-19 pandemic is visible across all indicators related to corporate performance. Compared to the end of 2019, the cost of debt for NFCs (interest expenses/obtained funding) remained stable as interest rates stayed very low (Graph 3.1(f)), but the interest coverage ratio (EBITDA/interest expenses) decreased. Therefore, overall firm's debt service burden increased. The stock of corporate deposits also increased during the COVID-19 pandemic, helped by the moratoria and the state wage support schemes, which indirectly helped reduce corporate expenses. Nevertheless, profitability decreased across all sectors except electricity, gas and water, with transportation and storage and services posting the most significant drop. On the positive side, the rebalancing of the financial structure of Portuguese firms continued in 2020, favouring equity to the detriment of debt (Graph 3.1(c)). The capital ratio (equity/total assets) of private corporations stood at 39.8% in Q3 2020, reaching the highest level ever recorded and resulting in a lower financial leverage for the Portuguese enterprises.

Household debt

Households' high indebtedness level remains an important vulnerability. Despite the significant improvement observed since 2012, the households' indebtedness level was still high before the outbreak of the COVID-19 pandemic (63.4% of GDP at the end of 2019, Table 3.2), with a significant part of the decline in the debt ratio achieved through cyclical GDP growth. The outbreak worsened the situation and households' debt levels increased by 3.5 pps (to 66.9% at the end of Q3 2020: Graph 3.2(a)). Portuguese households remain vulnerable to unexpected adverse shocks affecting their income (according to Eurostat's EU-SILC, in 2019 33% of households reported that they are unable to cover unexpected financial expenses) and credit moratoria are relevant for their immediate financial sustainability.

Credit moratoria have temporarily reduced households' liquidity problems. In September 2020, 17% of the stock of loans to households was under moratoria, one of the highest ratios in the EU (6.2% EU aggregate in June – latest available data, Graph 3.2(d)). The percentage of loans under moratoria was similar for housing loans and personal credits (approx. 19%) and lower for car loans (approx. 6%). These moratoria have been active since March 2020 and most of them are set to expire in September 2021. According to Banco de Portugal (BdP), a survey of seven of the largest banking institutions revealed that less than half of the households that were granted loan moratoria had experienced a fall in their income at the time of their application. This showed that a significant proportion of the households that applied for credit moratoria did so for precautionary reasons while overall the households' liquidity looked sound in the light of the increased saving rate and resilient employment and income rates.

The gross household saving rate increased significantly in 2020. The household saving rate stood at 11.7% of disposable income in Q3 2020 (Graph 3.2(e)), up by 4.3 pps. compared to the end of 2019 (in Q2 2020 the gross household saving rate had reached 18.9%, the highest value ever recorded). The increase in the rate was driven by reduced consumption associated with mobility restrictions that limited part of households' normal spending and by the high uncertainty that boosted precautionary savings. However, despite an increase in the stock of households' deposits, the flow of new deposits from private individuals recorded a rather negative growth rate in 2020 (22.6% y-o-y cumulative).

Table 3.1: **Non-financial corporations debt indicators, Portugal**

	Source	2003-07	2008-12	2013-17	2019	2020	2021f	20Q2	20Q3	20Q4
Stocks										
Debt, consolidated (% of GDP)	*(a,d)*	92	113	101	86	93		91	92	93
Debt, consolidated (% of potential GDP)	*(a,b,d)*	91	111	99	89	88		90	89	88
Prudential threshold (% of GDP)(1)	*(c)*	56	49	53	63	61	62			
Fundamental benchmark (% of GDP)(1)	*(c)*	58	64	66	60	65	63			
Debt, consolidated (% of gross operating surplus)	*(a,b,d)*	464	540	458	402	476		443	460	476
Interest paid (% of gross operating surplus) (3)	*(a,b)*	12.7	17.0	11.9	8.5	9.1		8.1	8.4	
Debt, consolidated (% of gross financial assets)	*(a,d)*	101	109	98	88	87				
Domestic loans in forex (% dom. Loans)	*(d)*	1.1	0.5	0.8	0.8	0.6		0.7	0.6	0.6
Flows										
Credit flows (transactions, % of GDP) (2)	*(a)*	5.8	4.4	-0.1	1.6	3.1	0.9	10.9	-0.8	-1.0
Benchmark for flows (% of GDP)(1)	*(c)*									
Investment (% of value added)	*(b)*	25.7	22.8	20.8	24.6	24.4	22.8			
Savings (% of value added)	*(b)*	17.7	18.4	23.2	21.8	20.6	25.7			
p.m. Banks NFC NPLs (% of NFC loans) (2)	*(d)*			*25.8*	*12.3*					

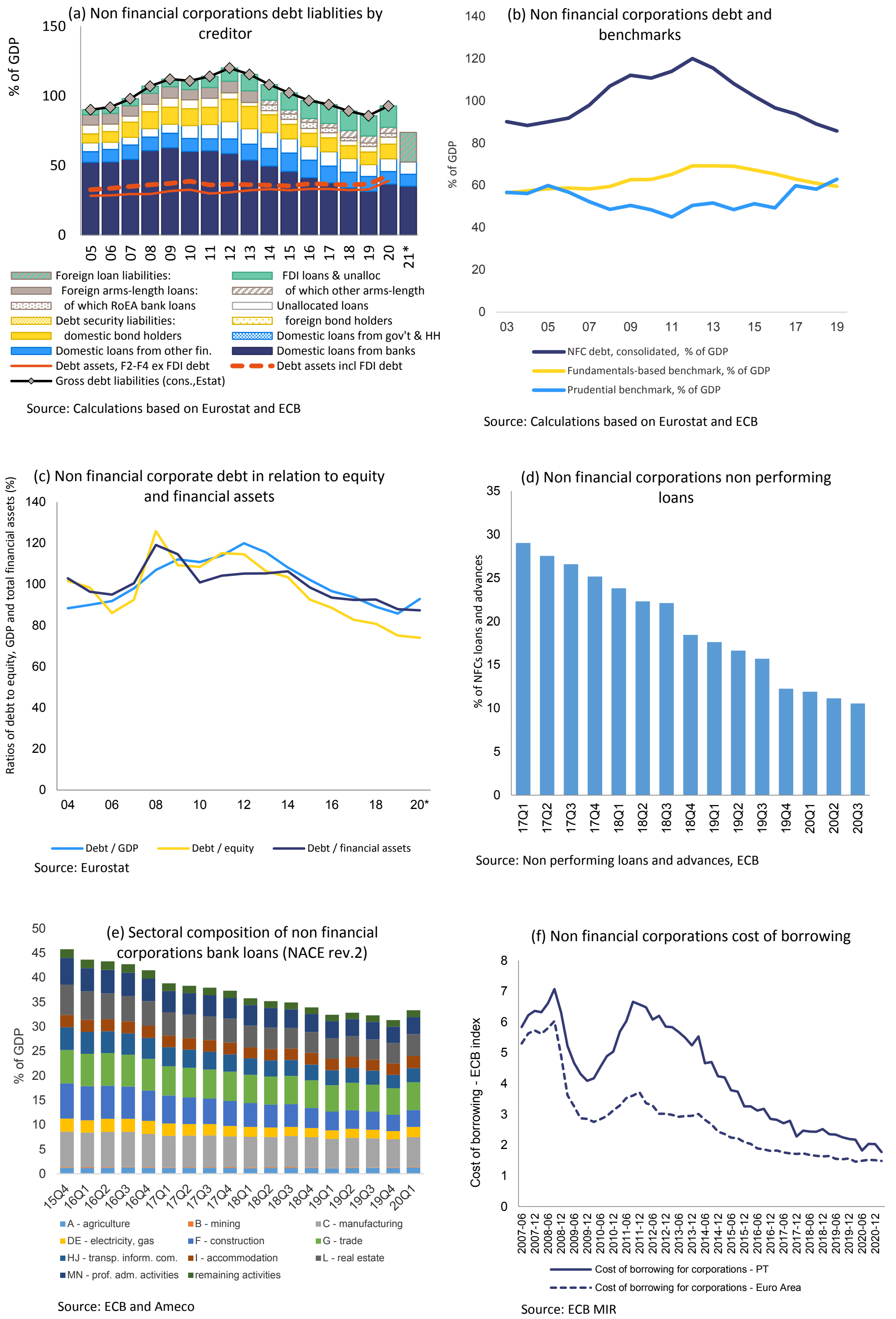
(f) European Commission forecast
(1) Benchmarks for flows (% of GDP) are estimated on the basis of non-consolidated flows.
(2) Gross non-performing bank loans and advances to Households and non profit institutions serving households (% of total gross bank loans and advances to Households and non profit institutions serving households).
(3) Gross non-performing bank loans and advances to Non-financial corporations (% of total gross bank loans and advances to Non-financial corporations).
(4) Quarterly data is annualized.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.

Table 3.2: **Household debt indicators, Portugal**

	Source	2003-07	2008-12	2013-17	2019	2020	2021f	20Q2	20Q3	20Q4
Stocks										
Debt, consolidated (% of GDP)	*(a,d)*	80	91	75	64	68		66	67	68
Debt, consolidated (% of potential GDP)	*(a,b,d)*	79	90	74	66	65		65	65	65
Prudential threshold (% of GDP)(1)	*(c)*	38	32	35	40	39	39			
Fundamental benchmark (% of GDP)(1)	*(c)*	39	43	41	35	39	37			
Debt (% of gross disposable income)	*(a,b,d)*	112	125	107	93	93		92	93	93
Interest paid (% of gross disposable income) (3)	*(a,b)*	3.4	3.5	1.3	0.4	0.3		0.3	0.3	
Debt (% of gross financial assets)	*(a,d)*	41.3	44.0	35.5	31.5	30.7		30.8	30.7	30.4
Share of variable rate loans for house purchase (%)	*(d)*	98.3	97.4	78.4	72.8	66.5				
Domestic loans in forex (% of dom. loans)	*(d)*	0.1	0.1	0.1	0.1	0.0				
Flows										
Credit flows (transactions, % of GDP) (4)	*(a)*	6.8	0.0	-1.3	0.7	1.1	0.3	0.1	1.7	2.0
Benchmark for flows (% of GDP)	*(c)*	2.8	0.8	-0.2	0.3	0.5	0.6			
Savings rate (% gross disposable income)	*(b)*	9.9	9.3	7.2	7.1	12.8	9.3			
Investment rate (% gross disposable income)	*(b)*	9.4	6.3	4.9	5.9	5.9	6.3			
p.m. Bank HH NPLs (% of HH loans) (2)	*(d)*			*8.0*						

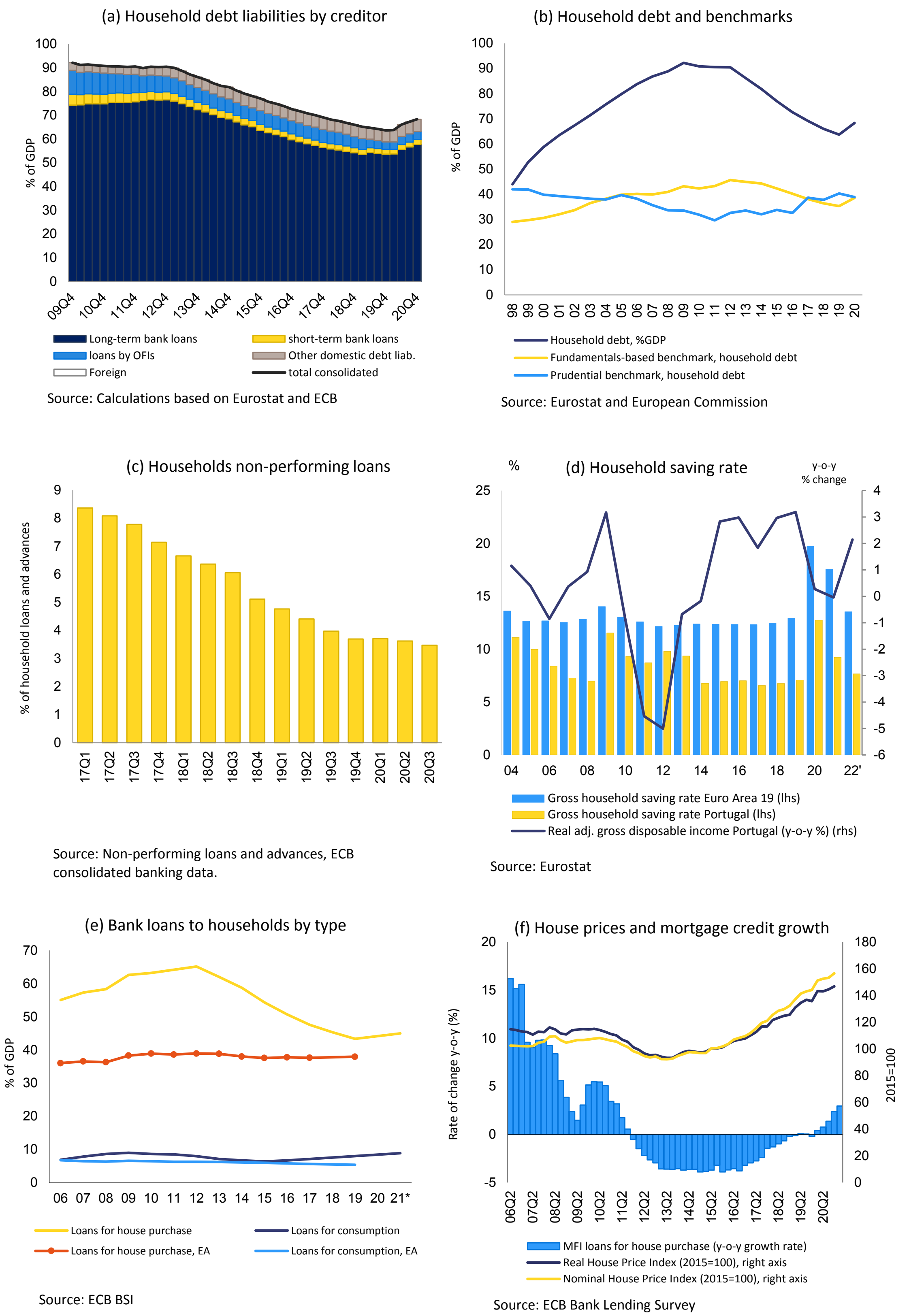
(f) European Commission forecast
(1) Benchmarks for flows (% of GDP) are estimated on the basis of non-consolidated flows.
(2) Gross non-performing bank loans and advances to Households and non profit institutions serving households (% of total gross bank loans and advances to Households and non profit institutions serving households).
(3) Quarterly data is annualized.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.

Graph 3.1: **Thematic Graphs: Non-financal corporate debt**



Source: European Commission Services

Graph 3.2: **Thematic Graphs: Household debt**



Source: European Commission Services