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In-depth review for Portugal

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

Accompanying the document

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

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On the basis of this in-depth review for Portugal undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2022 Spring Package" (COM(2022)600 final) that:

Portugal is experiencing imbalances. Vulnerabilities relate to high private, government and external debt in a context of low productivity growth. Non-performing loans have fallen considerably from high levels. After a temporary reversal in 2020 due to the COVID-19 crisis, those vulnerabilities resumed their downward trajectory in 2021. The current account balance turned negative in 2020 and 2021, mainly due to the pandemic-driven shock in the tourism sector, while the net international investment position improved considerably already in 2021, even beyond its pre-pandemic level. The private sector and government debt-to-GDP ratios resumed their downward trends in 2021 but remain above pre-pandemic levels and the former is still exceeding prudential levels. Going forward, private, government and external debts are expected to continue narrowing on the back of economic growth. The external position will also directly benefit from the RRF funds. Policy progress has been made to address imbalances and a successful implementation of the RRP can help in further narrowing them, but policy challenges remain.

CONTENTS

1. Introduction 3

2. Assessment of macroeconomic imbalances 4

3. Thematic chapter: External Imbalances 12

LIST OF TABLES

Table b.1.1: Selected exposures 9

Table 2.1: Selected economic and financial indicators (Part 1), Portugal 10

Table 2.2: Selected economic and financial indicators (Part 2), Portugal 11

Table 3.1: Selected external indicators 15

LIST OF GRAPHS

Graph b.1.1: Sectoral distribution of energy use and of energy imported from Russia 8

Graph b.1.2: Portugal goods and service trade balance – fossil trade contribution 8

Graph 3.1: Thematic Graphs: External imbalances 16

Graph 3.2: NIIP projections 17

Graph 3.3: Thematic Graphs: External Imbalances 17

1. INTRODUCTION

In 2021, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure (MIP), the Commission identified "macroeconomic imbalances" in Portugal. ([1]) These imbalances were related to high external, private and government debt in a context of low productivity growth. The 2022 Alert Mechanism Report concluded that a new in-depth review (IDR) should be undertaken for Portugal with a view to assess the persistence or unwinding of imbalances. ([2])

Portugal has returned to steady growth. ([3]) After a pandemic-driven contraction of 8.4% in 2020, the Portuguese economy rebounded by 4.9% in 2021. Growth is projected to accelerate further to 5.8% in 2022 before moderating to 2.7% in 2023. Nominal GDP in 2023 is forecast to be around 13.5% above its 2019 level. However, there are downside risks related to uncertainties in global supply chains and commodity prices in the context of the Russian aggression against Ukraine. Domestic demand is set to contribute substantially to growth in both 2022 and 2023, helped by the implementation of the Recovery and Resilience Plan (RRP). The current account balance is projected to remain negative over the forecast horizon, as the projected recovery in exports of services is outweighed by higher prices of energy imports in 2022. All labour market indicators, with the exception of hours worked, recovered to pre-pandemic levels in the second half of 2021. Along with the economic recovery, inflation rose substantially in the second half of 2021 paced by a steep increase in energy prices. In year-average terms, inflation is projected to rise from 0.9% in 2021 to 4.4% in 2022 and to moderate to 1.9% in 2023.

This in-depth review presents the main findings of the assessment of imbalances. The assessment is backed by a thematic section on the external position. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, assessments of structural issues made in previous IDRs and in the context of fiscal assessments are also considered, to the extent relevant. The MIP assessment matrix is published in the 2022 Country Report for Portugal. ([4])

([1]) European Commission (2021), European Semester Spring Package 2021, COM(2021) 500 final.
([2]) European Commission (2021), Alert Mechanism Report 2022, COM (2021) 741 final.
([3]) Forecast data are from European Commission (2022), European Economic Forecast: Spring 2022, Institutional Paper 172.
([4]) European Commission (2022), Country Report Portugal 2022, SWD(2022)623 final.

2. ASSESSMENT OF MACROECONOMIC IMBALANCES

Assessment of gravity, evolution and prospects of macroeconomic imbalances

Portugal's external position remains vulnerable but moved in a favourable direction in 2021. After a temporary deterioration in 2020 driven by the negative impact of COVID-19, the net international investment position (NIIP) resumed its positive trend in 2021. The NIIP amounted to -95.9% of GDP at the end of 2021, improving by around 9 percentage points in one year and surpassing the pre-pandemic level of -100% at the end of 2019. A substantial part of the improvement resulted from the rebound in GDP and favourable valuation changes, while the impact from transaction flows was rather limited, against the background of a muted recovery in the country's receipts from foreign tourism. Risks stemming from the large stock of external liabilities are partly offset by the NIIP structure, as non-defaultable instruments account for around 60% of net liabilities and are composed mostly of foreign direct investments (FDI).

The current account balance turned negative from 0.4% of GDP in 2019 to -1.1% in 2020 and 2021. The current account balance was slightly more than 1 percentage point below the estimated current account explained by fundamentals. In the light of the high prices of energy imports, this gap is set to widen somewhat in 2022 and to start narrowing afterwards, also in cyclically adjusted terms. The current account is also expected to remain below the balance required to reach the NIIP benchmarks at sufficient pace.

The country's exposure to foreign tourism contributed to a loss in the export market share. Portugal's exports of goods and services dropped by 10.7 percentage points more than global trade volumes in 2020 after persistent growth in previous years. This relative decline was, however, less pronounced in Portugal than in countries with similar exposure to foreign tourism such as Greece, Spain and Croatia. The export market share started to increase again in 2021 and is forecast to increase further in 2022.

Going forward, the NIIP will benefit from the projected substantial increase in nominal GDP, particularly in 2022. In the medium term, the NIIP could come close to the estimated prudential threshold, currently at -52% of GDP, while still remaining beyond the fundamentals-explained threshold of -12%. The projected positive net inflow through the country's capital account is set to broadly balance the projected net outflow through the current account in 2022 while the outlook for 2023 is more favourable. The projected trade flows suggest that the impact of the pandemic on the country's current account balance would not be fully unwound in 2022 and 2023 due to the expected continued weakness in international travels and tourism relative to the pre-pandemic trajectory, as well as the high prices of energy imports. The balance of payments is, however, set to continue to benefit from the projected stream of RRP grants in 2021-2026, estimated at more than 6% of the country's 2021 GDP. However, there are certain downside risks on the external side in light of high commodity prices due to the Russian aggression against Ukraine (see box 2.1).

Labour productivity changes are difficult to interpret due to the impact of labour hoarding during the COVID-19 pandemic. Portugal's economy was more severely affected by the COVID-19 pandemic than many other EU countries The country's productivity measured as GDP per employee declined relatively strongly, by 6.7% in 2020. In line with other countries, this figure is difficult to interpret as it is driven by labour hoarding due to the impact of the pandemic, and has a statistical effect of inducing an improvement once labour hoarding ends. In parallel, productivity in terms of hours worked improved by 1% in 2020, in part indicating the effectiveness of employment protection measures during the crisis. Labour productivity (GDP per employee) started to increase again, by 2.8% in 2021 and is forecast to increase by 4.8% in 2022, reflecting the economic recovery and phasing out of short-term work schemes. A full recovery of productivity to the pre-pandemic level is expected to take place in 2022

Total factor productivity growth outstripped labour productivity. Total factor productivity retained a relatively stable positive contribution to potential growth during the pandemic. Meanwhile, potential growth is projected to exceed its pre-pandemic rate from 2021 onwards, helped by the projected positive impact of the RRP.

Private indebtedness is declining again after a one-off increase in 2020. The economic contraction in 2020 pushed up private debt via the GDP denominator from 149% of GDP at the end of 2019 to 164% of GDP at the end of 2020. The ratio remained well below the peak of 211% of GDP in 2012 and the economic rebound in 2021 allowed for a renewed decline. Helped mainly by nominal growth in GDP, the share of private debt to GDP fell to 160% at the end of 2021 and a further decrease is expected in 2022-2023. Both corporates and households are estimated to have contributed to the decrease in the private debt ratio in 2021, after a one-off increase to 95% of GDP and 69% in 2020, respectively. Both ratios remained significantly above the estimated country-specific prudential and fundamentals-based benchmarks ([9]). For corporates, these benchmarks were estimated at 63% and 60%, respectively, and for households at 40% and 32%. Vulnerabilities in the debt structure, particularly in the corporate sector, remain. Risks persist that the phase-out of state-support measures and potential second-round effects on economic growth from Russia's unprovoked invasion of Ukraine could lead to further vulnerabilities associated to private sector debt. However, households' and corporates' deposits increased in 2020 and 2021, providing the private sector with a liquidity buffer.

The banking sector remained stable throughout the downturn caused by the pandemic. Portuguese banks maintained a strong financial position throughout 2020-2021, helped by debt moratoria and government measures in support of businesses and households. Most support measures ended in early 2021 and the credit moratoria expired at the end of September 2021. The sector made provisions to face future loan losses but initial data indicate that banks did not face a cliff-edge effect after the expiration of the moratoria. In parallel, NPLs continued to decline throughout 2020-2021, mainly through sales and write-offs, dropping to 3.9% in September 2021 and 3.5% at the end of 2021, down from 6.1% at end-2019, just before the onset of the pandemic. The NPL coverage ratio rose to 55% as of September 2021 from 51.5% before the pandemic. More recently, the strong post-COVID economic recovery is helping most banks to generate positive profit margins. The return on equity (ROE) reached 5.4% in the first three quarters of 2021. In the aggregate, banks display healthy balance sheets that would be able to shoulder a possible delayed increase in NPLs.

House price growth has regained momentum. The growth in real house prices moderated from 9.0% in 2019 to 8.0% in 2020. The growth rate declined further in the first quarter of 2021 but the economic recovery in 2021, along with low interest rates, brought new momentum to the market as the growth rate rose afterwards, leading to a year-average growth of 8.1% in 2021. Accordingly, the valuation gap, estimated at 15.4% in 2020, widened further in 2021. Loans for house purchases account for 45% of banks' credit to the private sector as of September 2021, slightly above the euro area average of 44%. The increase in mortgage lending was moderate in 2021 and below the corresponding increases in GDP and household incomes, while household deposits continued growing at a solid pace.

The public debt-to-GDP ratio decreased in 2021 supported by the economic rebound. Starting from a public debt-to-GDP of around 117% in 2019, it surged to about 135% in 2020, before dropping to around 127% in 2021. It is projected to remain on a declining path, decreasing to 115% of GDP in 2023, i.e. below its pre-pandemic level. At the same time, the Commission's fiscal sustainability assessment shows that Portugal faces high fiscal sustainability risks over the medium term and medium risks in the long term ([10]). The analysis confirms the unfavourable effect of the projected increase in ageing costs in Portugal. Country-specific factors mitigate Portugal's fiscal sustainability challenges, linked to its cash buffer, the recent lengthening of debt maturity, the relatively stable financing sources and favourable

([9]) 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).

([10]) See European Commission Country Report on Portugal for the latest results and the 'Fiscal Sustainability Report 2021', Institutional Paper 171, 25 April 2022 for methodological details.

financing conditions, as well as the currency denomination of debt. However, the size of public contingent liabilities adds certain risks.

Assessment of MIP relevant policies

Portugal has implemented policies in all areas of its macroeconomic imbalances and many new measures are expected to be implemented in the medium term. With the outbreak of the COVID-19 pandemic in early 2020, policy efforts were initially focused on temporary measures to address the impact of the pandemic, notably to safeguard the responsiveness of the National Health Service and to protect the labour market. The focus has gradually changed towards a wide range of policy commitments set in the country's RRP covering the period of 2021-2026. A large part of these commitments are expected to address directly or indirectly the existing macroeconomic imbalances in Portugal. In addition, the authorities have taken measures to address vulnerabilities in the financial sector, including for the smooth phasing out of the debt moratoria and mitigating risks related to the increase in house prices. In the labour market, measures have been implemented for a smooth normalisation of work in industries particularly affected by lockdowns.

Policies in support of Portugal's export base and energy efficiency are expected to improve the country's external balance in the medium and long run. Portugal's RRP contains policy measures and investments aimed at increasing the country's export base and industrialisation. Specific actions include the promotion of R&D and innovative investment in enterprises as part of the update of the Strategy for Technological and Enterprise Innovation 2018-2030. The document was adopted in December 2021. Investments in energy savings and the substitution of fossil fuels with green energy are also expected to support the external balance by reducing energy imports. In this area, the authorities have opened the first call for tender for industrial decarbonisation projects with priority given to projects with the highest decarbonisation efficiency. The authorities also launched the first tender for the selection of projects for the production of renewable hydrogen and renewable gases. Most of the energy saving and energy transition measures remain to be implemented until 2025.

Efforts to boost productivity are also essential for balancing Portugal's external position and debt ratios. Progress has been made over the past years with tackling rigidities in product and labour markets. However, a number of policy gaps still exist and are being addressed by measures in the country's RRP, together with Cohesion Policy Funds, particularly those related the education, digital skills, as well as improving the functioning of the judicial system and business regulations. In 2021, a new legal framework entered into force to support the cooperation of higher education institutions with the public administration and businesses. The framework is expected to address skill mismatches on the labour market. In addition, contracts were signed for the purchase of digital equipment for schools as part of the efforts to increase digital skills.

Capitalisation measures are expected to reduce risks related to the corporate debt structure. The setup of the state-owned promotional bank Banco Português de Fomento (BPF) in 2020 was designed to address the undercapitalisation of the corporate sector, particularly for vulnerable but viable firms affected by the pandemic. The capacity of BPF to support such firms was significantly increased in late 2021 with the setup of a EUR 1.3 billion capitalisation fund, financed by loan support under the RRP, and the adoption of the underlying investment policy. The measure is designed to provide equity and quasi-equity support that would indirectly mitigate risks of a possible increase in NPLs with the expiration of debt moratoria. In addition, to address risks in the banking sector related to the overvaluation in house prices, the central bank adopted a macroprudential recommendation aimed at lowering the average maturity for mortgage-backed loans to 30 years. The act came on top of existing macroprudential measures that had been successful in bringing down the loan-to-value ratio of housing loans below 80%.

Fiscal-structural reforms are key to strengthening Portugal's public debt sustainability in the medium term. Some measures were taken in past years in the areas of tax compliance, expenditure control, pensions, healthcare, state-owned enterprises, and public administration. However, policy gaps persist, notably related to the long-delayed implementation of the 2015 Budgetary Framework Law, which would be instrumental to improve the quality and composition of public finances, by prioritising growth-enhancing expenditure, strengthening spending efficiency and contributing to contain structural upward pressures on public current expenditure. In addition, vulnerabilities persist in the financial

sustainability of the National Health Service and in some state-owned enterprises. Reforms in these areas are embedded in Portugal's RRP and are expected to be implemented gradually over its lifetime. As a crucial step towards strengthening the governance and efficiency of state-owned enterprises, a new management contract template came into force in December 2021 to increase the performance, responsibility and accountability of public managers appointed to the respective Boards of Directors. In addition, Portugal's tax and social protection systems remain complex and there is scope to reduce the associated administrative burden, in particular by simplifying both frameworks and enhancing the efficiency of the respective administrations.

Conclusion

Portugal is facing vulnerabilities relating to high external, private and government debt in a context of low productivity growth. After a temporary reversal due to the outbreak of COVID-19 in 2020, Portugal saw a narrowing of those vulnerabilities in 2021. High levels of NPLs have fallen considerably. In 2021 the NIIP improved further beyond its pre-pandemic level, but remains significantly beyond the estimated prudential threshold. The current account balance turned negative in 2020-2021, mainly due to the pandemic-driven shock in the tourism sector. The ratios of private and government debt to GDP resumed their downward trajectory in 2021, but remained above their pre-pandemic levels. The country's large exposure to foreign tourism continues to weigh on the external sector but the RRP grants are expected to support the NIIP in the medium term. Private, government and external debt-to-GDP ratios are expected to continue their downward adjustment this year and next, also thanks to the projected nominal GDP growth. Nevertheless, the country's private sector debt indicators remain significantly beyond the estimated prudential and fundamentals-explained thresholds. Portugal's exposure to Russia seems limited. Nonetheless, the energy crisis is likely to affect Portugal's external position (see box 2.1).

Policy progress has been made to address imbalances, also through the RRP, but policy challenges remain. Authorities have taken steps in support of the country's export capacity and investment potential, as well as to mitigate structural weaknesses in the corporate sector, notably through the creation of a EUR 1.3 billion (0.6% of GDP) capitalisation fund. In the area of education, incremental steps are being taken in order to increase digital education and training for all. At the same time, policy action has been taken to improve the financial sustainability of state-owned enterprises, through a new management contract containing a system of incentives to support managers' performance. Moreover, a number of measures is foreseen in Portugal's RRP and is expected to be implemented gradually to enhance the quality and composition of public finances, strengthen the financial sustainability of the National Health Service, and further mitigate vulnerabilities in some state-owned enterprises. Weaknesses in the business environment persist, in particular related to sector-specific regulatory and administrative burden, including regulatory restrictions in regulated professions. Reforms in these areas are also embedded in Portugal's RRP. The tax and social protection systems remain complex and the ensuing administrative burden could be reduced, in particular by simplifying both frameworks and enhancing administrative efficiency.

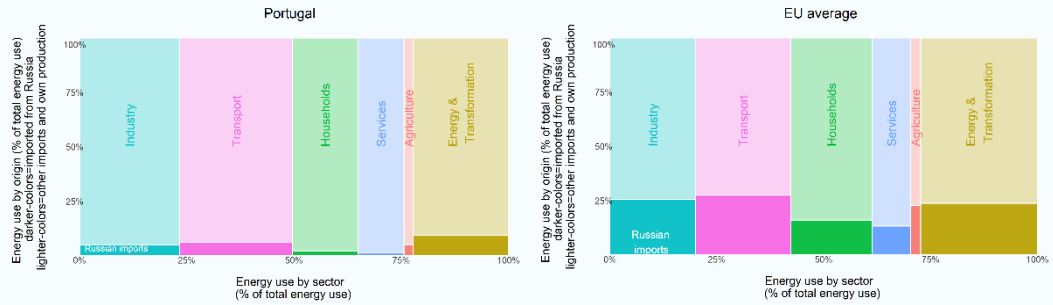
Based on the findings in this in-depth review, the Communication "European Semester – 2022 Spring Package" ([11]) sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Portugal, in line with Regulation 1176/2011.

([11]) European Commission (2022), European Semester Spring Package 2022, COM(2022)600 final.

Box 2.1: Exposures to the commodity price surge, and to Russia

This box summarizes risks and exposures regarding the commodity price surge, and the importance of direct links with the Russian economy. The surge of commodity prices since 2021 had been aggravated by the Russian military aggression against Ukraine. This box reviews the risks for the macroeconomic vulnerabilities in Portugal. Available data suggests that exposures to energy prices are a concern, although exposures to Russia are significantly below the EU average. The sanctions imposed by the EU and its partners on Russia and Belarus will have side effects for the Portuguese economy, although they seem very limited. However, the energy crisis is likely to affect Portugal more noticeably via the surge in energy prices.

Graph b.1.1: Sectoral distribution of energy use and of energy imported from Russia



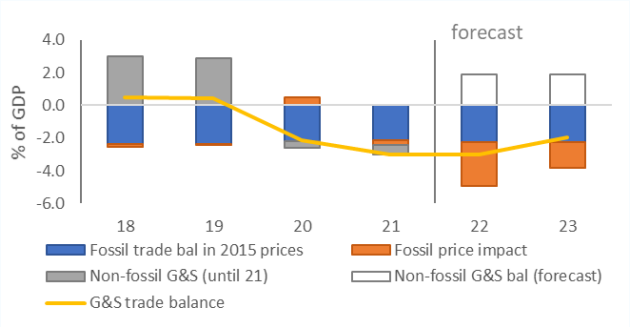
Notes: The left panel displays the distribution of primary energy usage in Portugal according to Eurostat energy balances. The horizontal axis displays the relative importance of energy-consuming sectors. The vertical axis displays the importance of energy importance from Russia in satisfying that need. Note that this dependence on Russia differs according to sector's use of natural gas vs oil and coal. For comparison, the right hand panels displays the same concept for the EU aggregate. Russian imports include oil and petroleum products,natural gas and solid fossil fuels.
Sources: Eurostat and European Commission services calculations.

The distribution of energy usage by sector is roughly comparable to the EU average with the exception of the transport sector (Graph b.1.1). Land transport is the main consumer of oil and petroleum products in the transport sector (96% in 2020). In 2020 oil and petroleum PRODUCTS represented 42% of the Portuguese energy mix.

Despite the strong reliance on gas and oil, the Portuguese economy depends significantly less on imports from Russia than the EU average. In 2020, Portugal imports almost no crude oil from Russia, and imports only 10% of its gas from Russia, significantly lower than the EU average at 44%. However, the net gas imports amount to 0.8% of GDP, slightly above the EU average (0.6%). In 2019, gas imports came mostly from Nigeria (54%), followed by the UAE (16%) and Algeria (9%) while oil imports from Brazil (20%), Spain (14%), Nigeria (13%) and Angola (8%). Therefore, the energy crisis has an impact mainly through price increases and not through potential energy supply disruptions. In addition, renewables represent a significant share of the Portuguese energy mix (31%) and they are projected to largely replace fossil fuels in the next years. This is expected to partly offset the direct impact of the energy price increase on household and companies in the medium term.

The fuel price surge is likely to have a strong impact on the trade balance. The commodity price increase is expected to depress the trade balance by around 2.7 pp. of GDP in 2022 (see Graph 2). Nonetheless, the net lending/borrowing (current plus capital account) is expected to remain in a small surplus.

Graph b.1.2: Portugal goods and service trade balance – fossil trade contribution



Notes: The graph displays the trade balance as % of GDP, and highlights net trade of petroleum products, natural gas and solid fossil fuels (mainly coal), in 2015 import prices. The 'fossil price impact' component details the impact of price changes on the (also changing) real trade balance. 2022 and 2023 figures reflect central assumptions of the Commission spring forecast, notably combining the forecasted fossil price evolution with broadly forecasted import quantities of fossil energy sources.

Portugal's financial links to Russian entities are limited. Table b.1.1 shows that portfolio and other investment assets held in and towards Russia are well below EU average. Also the tourism sector can be affected only negligibly as the share of Russian tourists was relatively low and well below the EU average.

Table b.1.1: Selected exposures

Trade & financial exposures	unit	PT	EU
Domestic value added embodied in exports to Russia	% of GDP	0.1%	0.4%
Non-energy Russian import content in final demand	% of GDP	0.2%	0.4%
Russian tourist nights spent	% of total 2019	1.0%	2.7%
FDI assets held in Russia	% of 2020 GDP	0.0%	2.5%
Portfolio & other inv. assets held in Russia	% of 2020 GDP	0.0%	0.9%
FDI liabilities towards Russia	% of 2020 GDP	0.1%	1.2%
Portfolio & other inv. liabilities towards Russia	% of 2020 GDP	0.1%	1.1%
Consolidated banking exposures towards Russia	% of 2021 GDP	0.1%	0.5%

Energy mix	unit	PT	EU
Solids fossil fuels (incl. peat)	% of Gross inland consumption 2020	2.7%	10.8%
Oil and petroleum products	% of Gross inland consumption 2020	42.1%	32.7%
Natural gas	% of Gross inland consumption 2020	24.4%	24.4%
Renewables and waste	% of Gross inland consumption 2020	30.8%	19.0%
Nuclear	% of Gross inland consumption 2020	0.0%	13.1%
Commodity exposures	**unit**	**PT**	**EU**
Net petroleum imports from all countries	% of GDP 2021	1.6%	1.2%
Crude oil imports from Russia '20	% of oil imports	0.0%	25.7%
Net gas imports from all countries	% of GDP 2021	0.8%	0.6%
Gas imports from Russia '20	% of gas imports	9.7%	43.6%

Notes: data source Eurostat for commodity exposures, European Commission Figaro for value-added exposures, BIS for consolidated banking exposures, European Commission FinFlows for other financial exposures. Energy gross inland consumption excludes net imports of electricity and derived heat.

Table 2.1: **Selected economic and financial indicators (Part 1), Portugal**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	forecast 2023
Real GDP	1.1	-1.4	1.4	2.8	2.7	-8.4	4.9	5.8	2.7
Potential growth (1)	1.0	-0.4	0.4	1.6	1.6	1.1	1.6	2.0	2.0
Contribution to GDP growth:									
Domestic demand	1.0	-2.8	1.5	2.8	3.4	-5.0	4.9	4.5	2.8
Inventories	0.1	-0.1	0.1	0.3	-0.3	-0.6	0.2	0.0	0.0
Net exports	-0.1	1.5	-0.2	-0.3	-0.4	-2.9	-0.2	1.3	-0.1
Contribution to potential GDP growth (1):									
Total Labour (hours)	-0.3	-1.1	0.2	0.8	0.5	0.4	0.6	0.8	0.7
Capital accumulation	0.9	0.3	-0.2	0.0	0.1	-0.1	0.0	0.2	0.3
Total factor productivity	0.4	0.5	0.4	0.8	1.0	0.8	1.0	1.0	1.0
Output gap (2)	-0.6	-1.1	-1.6	2.4	3.5	-6.3	-3.3	0.3	0.9
Unemployment rate	8.6	12.6	13.1	7.2	6.7	7.0	6.6	5.7	5.5
Harmonised index of consumer prices (HICP)	2.7	1.9	0.6	1.2	0.3	-0.1	0.9	4.4	1.9
GDP deflator	3.0	0.6	1.6	1.8	1.7	1.9	0.7	2.9	3.1
External position									
Current account balance (% of GDP), balance of payments	-8.8	-8.0	0.9	0.6	0.4	-1.1	-1.1	-1.7	-0.6
Trade balance (% of GDP), balance of payments	-7.5	-5.4	1.4	0.9	0.8	-1.9	-2.6	.	.
Primary income balance (% of GDP)	-1.9	-3.2	-2.2	-2.4	-2.4	-1.4	-1.2	.	.
Secondary income balance (% of GDP)	0.7	0.6	1.7	2.0	2.0	2.2	2.7	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-1.2	-0.5	0.1	0.3	0.3	0.4	0.3	0.4	0.5
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-0.5	0.8	-0.7	-1.1	-1.1	-1.1	-1.8	-1.7	-1.4
Capital account balance (% of GDP)	1.5	1.5	1.2	1.0	0.9	1.1	1.8	.	.
Net international investment position (% of GDP)	-73.7	-107.8	-116.8	-106.4	-100.0	-104.8	-95.9	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-41.3	-71.3	-70.2	-55.3	-46.7	-46.9	-36.6	.	.
Net FDI flows (% of GDP)	0.3	-2.4	-2.9	0.0	-0.7	2.9	-0.3	-2.2	1.8
Competitiveness									
Unit labour costs (ULC, whole economy)	1.4	-0.2	0.6	3.4	2.8	9.3	1.0	-0.6	0.8
Nominal compensation per employee	3.3	0.4	1.1	3.9	4.8	2.0	3.8	4.2	2.6
Labour productivity (real, hours worked)	1.4	1.1	0.3	-0.1	1.5	1.0	0.4	1.0	0.5
Real effective exchange rate (ULC)	0.0	-2.0	0.0	2.5	-0.3	.	.	.	.
Real effective exchange rate (HICP)	0.4	-0.8	-0.2	1.0	-1.8	0.8	-1.7	.	.
Export performance vs. advanced countries (% change over 5 years)	6.1	-3.5	2.1	6.1	6.6	-0.4	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	171.2	203.4	180.6	155.1	149.5	164.1	160.0	.	.
Household debt, consolidated (% of GDP)	79.5	90.6	77.4	66.0	63.5	69.5	68.1	.	.
Household debt, fundamental benchmark (% of GDP) (6)	38.6	40.6	37.6	31.7	30.4	32.9	31.5	.	.
Household debt, prudential threshold (% of GDP) (6)	37.8	32.3	33.7	37.3	40.4	40.3	40.4	.	.
Non-financial corporate debt, consolidated (% of GDP)	91.7	112.8	103.3	89.1	86.0	94.6	91.9	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	57.4	62.8	65.9	60.2	58.6	63.8	62.0	.	.
Corporate debt, prudential threshold (% of GDP) (6)	56.2	48.6	51.4	57.5	63.0	64.2	64.4	.	.
Private credit flow, consolidated (% of GDP)	12.6	4.4	-1.9	0.8	2.6	4.4	4.9	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-4.0	-1.7	3.4	-0.2	-0.9	-0.5	-0.9	-0.1	0.0
Households, net lending (+) or net borrowing (-) (% of GDP)	1.6	3.0	2.7	1.8	1.8	6.2	4.4	2.3	2.6
Net savings rate of households (% of net disposable income)	2.6	1.5	-0.9	-2.5	-2.2	3.3	1.3	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of Commission's T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) 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. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.
Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

Table 2.2: **Selected economic and financial indicators (Part 2), Portugal**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	forecast 2023
Housing market									
House price index, nominal	1.5	-1.7	4.3	10.3	10.0	8.8	9.4	.	.
House price index, deflated	-1.8	-2.9	3.4	8.6	9.0	8.0	8.1	.	.
Overvaluation gap (%) (7)	-0.3	-2.9	-10.9	2.0	8.0	15.4	22.0	.	.
Price-to-income overvaluation gap (%) (8)	-0.5	-8.3	-11.1	0.1	5.2	15.6	21.6	.	.
Residential investment (% of GDP)	5.8	3.7	2.6	3.1	3.2	3.4	3.7	.	.
Government debt									
General government balance (% of GDP)	-5.0	-7.8	-4.4	-0.3	0.1	-5.8	-2.8	-1.9	-1.0
General government gross debt (% of GDP)	69.9	101.4	130.6	121.5	116.6	135.2	127.4	119.9	115.3
Banking sector									
Return on equity (%)	13.8	0.3	-6.1	-0.9	2.0	-1.7	.	.	.
Common Equity Tier 1 ratio	6.7	8.1	11.9	13.4	14.7	15.5	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances)	1.2	4.1	12.2	7.6	4.9	3.9	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	16.1	9.4	6.1	4.9	4.0	.	.
Cost of borrowing for corporations (%)	5.1	5.6	3.6	2.5	2.2	2.0	2.0	.	.
Cost of borrowing for households for house purchase (%)	4.0	3.6	2.4	1.4	1.1	0.8	0.8	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

3. THEMATIC CHAPTER: EXTERNAL IMBALANCES

Portugal's external position deteriorated with the COVID-19 crisis, also in part because of the impact of the crisis on tourism, but the NIIP improved strongly in 2021. This warrants a more detailed analysis this year. In 2020, the NIIP was at -105% of GDP, compared to its prudential benchmark of -52% and its fundamental benchmark of -12% of GDP. Its substantial improvement in 2021, to -96% of GDP, was mainly driven by GDP growth and favourable valuation changes. Still, the NIIP remained one of the most negative in the EU. The NIIP excluding non-defaultable instruments (NENDI) improved from -47% of GDP in 2020, to -37% in 2021. As the rest of the NIIP is composed mostly of foreign direct investments (FDI), a more favourable NENDI partly offsets the risks of outflows related to potential abrupt changes in the external market environment (Graph 2.1.d). As for the sectoral composition of the NIIP, the government net position improved from -64% of GDP in 2020 to -54% in 2021, while other segments, smaller in net terms, remained fairly stable (Graph 2.1.f).

The COVID-19 pandemic temporarily stopped the external adjustment trend

Portugal's net international investment position (NIIP) improved from its lowest level of -124% at the end of 2014 to -100% of GDP as of the end of 2019. The adjustment in the NIIP was also supported by a substantial correction of Portugal's current account balance (Table 2.1). Huge current-account deficits exceeding 10% of GDP until 2010 had started to decline from 2011 onwards and moved to a small surplus in 2013, which was maintained until 2019. This adjustment was driven by a sharp contraction of aggregate demand, including through gradual improvements in government's and corporates' net borrowing position (Graph 2.1.b). The strong growth in Portugal's tourism sector played a key role in the external adjustment during that period. The service balance improved from 3.6% of GDP in 2009 to 8.4% in 2019. The balance of goods also improved during the same period, from -10.4% to -7.6%.

The improving NIIP trajectory from before the COVID-19 pandemic was paused in 2020 before recovering in 2021(Graph 2.1.d). The initial decline largely reflected a denominator effect due to the decline in GDP. Relative to potential GDP, the NIIP even slightly improved in 2020. The net inflow of FDI dropped significantly in 2020, against the backdrop of unprecedented global market upheavals and uncertainties, but recovered in 2021. The NIIP ratio resumed its positive trajectory in 2021, reaching -95.9% at the end of the year, and is set to improve further in 2022 and 2023. The NENDI improved to -36.6% of GDP in 2021.

The current account balance turned negative from 0.4% of GDP in 2019 to -1.1% in 2020 and 2021. This deterioration reflected higher government net borrowing related to fiscal support measures, which was partly cushioned by an increased savings surplus of the household sector in 2020 (Graph 2.1.b). Output dropped more sharply than demand (Graph 2.1.a) and the export market share declined by 9.8% in 2020. The current account balance was slightly more than 1pp below the estimated current account explained by fundamentals but the gap to norm is projected to narrow going forward, also in cyclically adjusted terms. The current account is also expected to remain slightly below the balance required to reach the NIIP benchmarks at sufficient pace (Table 2.1).

Both exports and imports declined strongly in 2020 due to the crisis and have recovered unevenly. Imports have rebounded fast after the initial shock as domestic demand has gained momentum, while the recovery of exports has been comparatively limited, leading to a deterioration of the current account balance. The surplus in trade with services contracted from 8.4% of GDP in 2019 to 4.3% in 2020, mainly reflecting the huge drop in travel receipts (Graph 2.1.c). It improved only slightly in 2021, to 4.5% of GDP. The deficit in trade in goods narrowed, from -7.6% in 2019 to -6.3% in 2020, before expanding again to -7.1% in 2021. The UK's withdrawal from the EU also weighs on exports and investment, as the UK was the destination of around 6% of goods exports and the largest market for travel exports (around 18% of total) in 2019. The contraction of exports to the UK was stronger than that of overall exports in

2020. ([17]) The primary income has become less negative, while the secondary income balance, that includes current EU transfers, has remained positive and slightly increased with the COVID-19 pandemic. Overall, the current account remained stable in 2021.

The current account balance is forecast to remain negative, at -1.7% of GDP in 2022 and -0.6 % in 2023. The projected slow recovery in the current account reflects expectations that the foreign tourism sector is facing scarring effects, both on the supply and demand side, and is not expected to reach its pre-pandemic level before 2023. Moreover, going forward the increase in energy prices may weigh on the balance of goods (Graph 2 in Box 2.1). The country's external position, and particularly the capital account, is expected to benefit from the grants under the Recovery and Resilience Facility in the period of 2022-2026 that would help reduce the net stock of external liabilities.

During the COVID-19 pandemic competitiveness indicators temporarily worsened, but started to recover since 2021, so that the implications for external balances appear to be limited. The export market share declined by 9.8% in 2020, partly reflecting the importance of the tourism sector. However, it increased by 2.8% in 2021 and is forecast to increase by 7.3% in 2022. Unit labour cost growth increased sharply, by 9.3% in 2020, due to labour hoarding associated to the COVID-19 crisis, similar to other countries. This is a statistical effect that makes unit labour costs difficult to assess in 2020. Unit labour costs increased further by 1.0% in 2021, but are forecast to decline by 1.4% in 2022. Nominal wages per worker increased by 2.0 in 2020 and 3.8% in 2021 and are forecast to increase by 4.2% in 2022. Labour shortages in some sectors may result in additional wage pressure, also because some workers may have changed their profession during the pandemic. This may weigh on cost-competitiveness going forward.

Medium-term NIIP projections show that Portugal could substantially improve its NIIP position by 2031 (Graph 3.2), if it maintains its trade balance at current levels. Under the baseline scenario the NIIP would improve to around -55% of GDP by 2031. Under a more adverse illustrative scenario describing a hypothetical slower tourism recovery than in the baseline (see the footnote to Graph 3.2 below), the NIIP would still come close to -66% of GDP by 2031. A more optimistic illustrative scenario (see the footnote to Graph 3.2) would result in an NIIP of -44% in 2031.

A sustained reduction in the NIIP ratio, without a significant increase in the current account balance, requires sustainable growth. The adjustment to a stronger external position in the medium-term will require continuous moderate current account surpluses and sustained nominal output growth. This requires productive investments, as included in the Portugal's RRP. It contains policy measures and investments aimed at increasing the country's export base and industrialisation, including the promotion of R&D and innovative investment in enterprises. In this context, the update of the Strategy for Technological and Enterprise Innovation 2018-2030 was adopted in December 2021. Ongoing investments in energy savings and renewable energy are also expected to support the external balance by reducing imports of energy, particularly in the current context of high energy prices. This process may be accelerated by the energy security of supply concerns that emerged in context of the war in Ukraine. The capital account will also continue to be supported by capital transfers under the Recovery and Resilience Facility. Grants under the Recovery and Resilience Facility over 2021-2026 are estimated to exceed 6% of the 2021 GDP.

Portugal's tourism sector started to recover recently, but vulnerabilities remain

Portugal's exposure to tourism played a key role in the external adjustment prior to the COVID-19 crisis. The sector of accommodation and food service activities amounted to 6.1% of total gross value added (GVA) in 2019, compared to 2.9% on average in the EU. The strong growth in Portugal's tourism sector played a key role in the external adjustment before the COVID-19 crisis, with the travel balance expanding from 2.4% of GDP in 2009 to 6.1% in 2019. It has a strong international character, with cross-border tourists accounting for roughly 65% of nights spent in tourist accommodation establishments and with exports of travel (tourism) services at 37% of total exports in 2019. This helped the current account balance improve from -10.3% of GDP in 2009 to 0.4% in 2019. Net of travel receipts, the current account adjustment would have been much weaker from -12.7% of GDP to -5.7% for the same period.

([17]) OECD (2021), OECD Economic Surveys: Portugal 2021, OECD Publishing, Paris, https://doi.org/10.1787/13b842d6-en.

Portugal's large tourism sector was heavily affected at the onset of the COVID-19 pandemic. After the outbreak of the pandemic, tourism collapsed quickly, reaching its trough in April 2020, with almost no nights spent in touristic establishments (Graph 2.1.g). The travel balance declined to 2.5% of GDP in 2020, reflecting the strict containment measures during the first wave of the COVID-19 pandemic. The GVA share of the accommodation and food sector dropped by almost half, to 3.6% in 2020. Employment in the accommodation sector held up closer to pre-pandemic levels, helped by government support measures, especially short-term work schemes. However, it fell to 75% of its 2019 level in Q3 2021, compared to 90% in the EU as a whole.

The tourism sector started to recover recently, but is still lagging behind its pre-pandemic level. The travel balance increased in the third quarter of 2021, to 5.6% of GDP. Nights spent in tourism establishments recovered from 38% of their 2019 level in October 2020 to 88% in October 2021. Tourism activity recovered more dynamically in the second half of 2021 and the recovery of domestic tourism was swifter and stronger than of foreign tourism.

The pandemic has had some scarring effects on the tourism sector, which may also affect the performance of the sector going forward. Bankruptcies in the accommodation and food sector remain elevated, whereas new business registrations continue to remain below 2019 levels (Graph 2.1.i). The NPL ratio in the tourism sector remained relatively stable during the loan moratoria introduced in response to the COVID-19 crisis, effective until the end of September 2021. However, the NPL ratio in the sector increased to 8.6% in Q3 2021, compared to 6.6% in Q3 2019 (Graph 2.1.h). A large share of Portuguese firms in the sector are small, undercapitalised, and therefore vulnerable to economic shocks. ([18])

While many tourism establishments resumed business quickly once demand picked up, investment activity may remain subdued and the sector may find it more difficult to adjust to changing consumption patterns. This would also affect the external balance of Portugal going forward. While the RRP does not envisage specific measures targeted exclusively on tourism services, companies in the sector can be expected to benefit from the EUR 1.3 billion capitalisation fund set up in 2021. The measure is designed to provide equity and quasi-equity support to vulnerable but viable firms and it is estimated that a large share of these firms are in the tourism sector. In addition, the sector could benefit from measures designed to support digital skills, education and training.

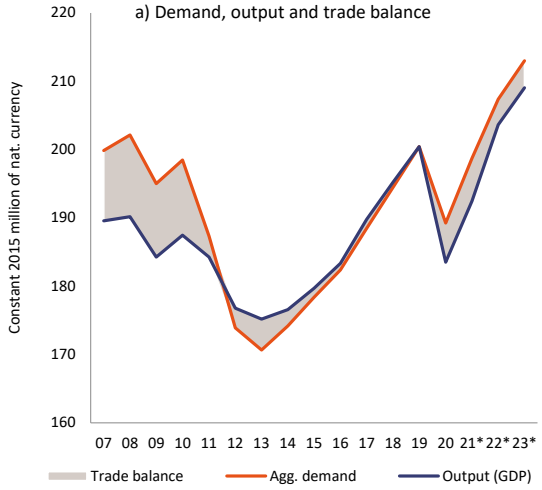
([18]) OECD (2021), OECD Economic Surveys: Portugal 2021, OECD Publishing, Paris, https://doi.org/10.1787/13b842d6-en.

Table 3.1: **Selected external indicators**

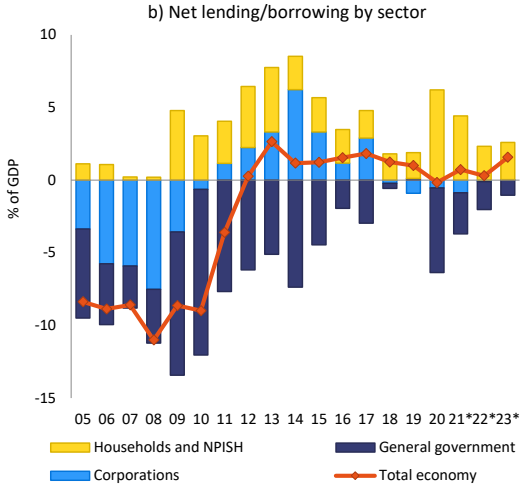
		2003-07	2008-12	2013-17	2018	2019	2020	2021	2022f	2023f
Flows [1]	*Source:*									
CA balance as % of GDP, NA	*(b)*	-8.9	-7.8	0.5	0.3	0.1	-1.2	-1.1	-1.7	-0.7
CA balance as % of GDP, BoP	*(a)*	-8.8	-8.0	0.9	0.6	0.4	-1.1	-1.1	-1.7	-0.6
Cyclically adj. CA balance as % of GDP [2]	*(c)*	-9.7	-7.6	0.5	1.2	1.5	-1.8	-2.1	-0.9	0.0
CA req. to stabilize NIIP above -35% [3]	*(c)*	-0.5	0.8	-0.7	-1.1	-1.1	-1.1	-1.8	-1.7	-1.4
CA explained by fundamentals (CA norm) [4],[8]	*(c)*	-1.2	-0.5	0.1	0.3	0.3	0.4	0.3	0.4	0.5
Required CA for specific NIIP target [5]	*(c)*	0.6	2.5	2.0	0.9	0.9	0.9	0.3	0.5	0.8
Trade bal. G&S, % of GDP, NA	*(b)*	-7.7	-5.8	0.8	0.5	0.5	-2.1	-3.0	-2.8	-1.8
Required TB for specific NIIP target [5]	*(c)*	1.4	3.5	1.2	-0.2	-0.5	-0.6	-1.1	-0.9	-0.7
Stocks										
NENDI as % of GDP	*(a)*	-41	-71	-70	-55	-47	-47	-37		
of which: net portfolio debt	*(a)*	-4	-18	-9	0	1	2	5		
of which: net mutual fund shares	*(a)*	4	5	9	10	13	15	18		
of which: net other investment	*(a)*	-47	-65	-79	-76	-70	-75	-74		
NIIP as % of GDP	*(a)*	-74	-108	-117	-106	-100	-105	-96	-89	-86
Prudential NIIP/NENDI benchmark [8]	*(c)*	-53	-52	-51	-53	-54	-52	-52	-53	-53
Fundamentally expl. NIIP benchmark (NIIP norm	*(c)*	-11	-13	-14	-12	-12	-12	-10	-10	-9
Gen. Government NIIP	*(a)*	-42	-57	-77	-59	-58	-64	-54		
Private Sector NIIP	*(a)*	-14	-20	-36	-44	-47	-52	-56		
of which: Net FDI [6]	*(a)*	-10	-16	-28	-32	-34	-38	-40		
MFI (excl CB) NIIP	*(a)*	-43	-31	-8	-9	-7	-2	1		
Oth. financials NIIP	*(a)*	15	3	6	7	13	16	18		
Central bank NIIP	*(a)*	10	-3	-2	-2	0	-2	-6		
of which: Reserves	*(a)*	5	8	10	11	10	12	14		
of which: Target2	*(a)*		-26	-36	-40	-36	-40	-38		
Value-added trade and capital account										
VA imports % of agg. demand [7]	*(d)*	29	29	30						
Capital account bal. as % of GDP, NA	*(b)*	2	1	1	1	1	1	2	2	2
Indicators in % of potential GDP						0.0	0.0	0.0	0.0	0.0
CA balance as % of potential GDP, NA	*(b,c)*	-8.8	-7.8	0.5	0.3	0.1	-1.2	-1.0	-1.7	-0.7
CA balance as % of potential GDP, BoP	*(a,c)*	-8.8	-8.0	0.9	0.6	0.5	-1.0	-1.1	-1.7	-0.6
Cyclically adj. CA balance as % of potential GDI	*(c)*	-9.7	-7.5	0.5	1.2	1.5	-1.7	-2.0	-0.9	0.0
Trade bal. G&S, as % of potential GDP, NA	*(b,c)*	-7.6	-5.7	0.8	0.5	0.5	-2.0	-2.9	-2.8	-1.8
NENDI as % of potential GDP	*(a,c)*	-41.1	-70.5	-68.9	-56.6	-48.4	-43.9	-35.4		
NIIP as % of potential GDP	*(a,c)*	-73.4	-106.5	-114.8	-108.9	-103.5	-98.2	-92.7	-89.7	-86.4
Capital account bal. as % of potential GDP, NA	*(b,c)*	1.5	1.4	1.2	1.0	0.9	1.0	1.7	2.0	2.2

(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.
(2) Cyclically adjusted CA is the CA adjusted for the domestic and foreign output gaps, taking into account trade openness.
(3) The average CA needed in order to stabilise the NIIP is based on European Commission"T+10"medium-term 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 European Commission "T+10" medium-term 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.
Source: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) WIOD database.

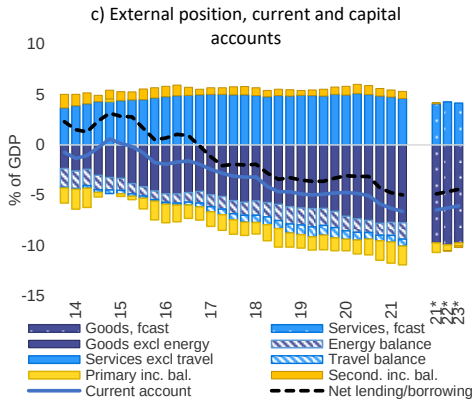
Graph 3.1: **Thematic Graphs: External imbalances**



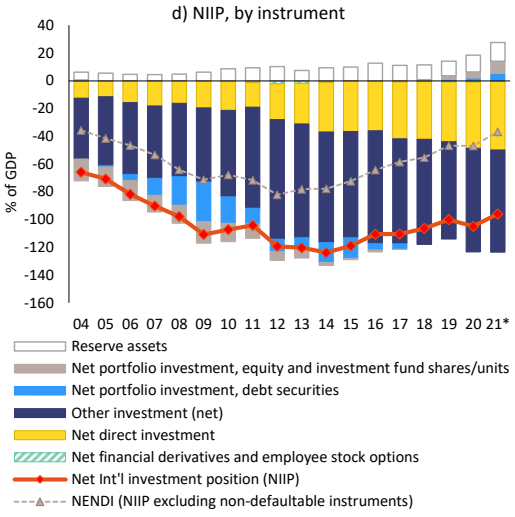
source: Ameco, Commission services



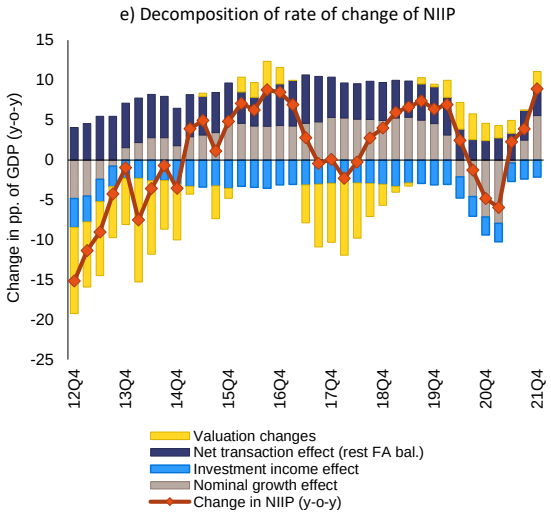
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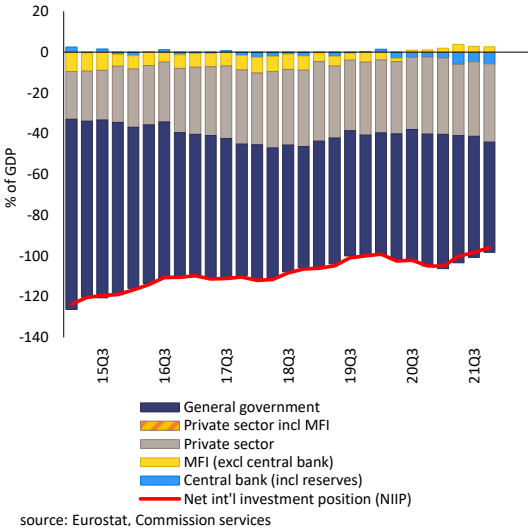
source: Eurostat, Commission services,Comext
Note: Moving average over four quarters



source: Eurostat, Commission services



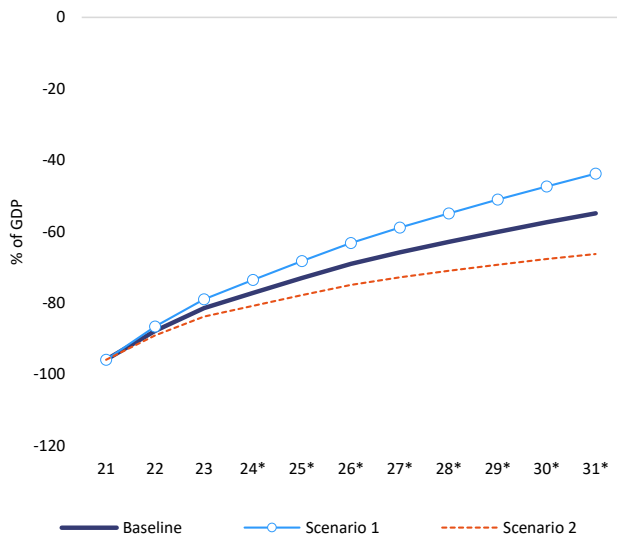
source: Eurostat, Commission services



source: Eurostat, Commission services

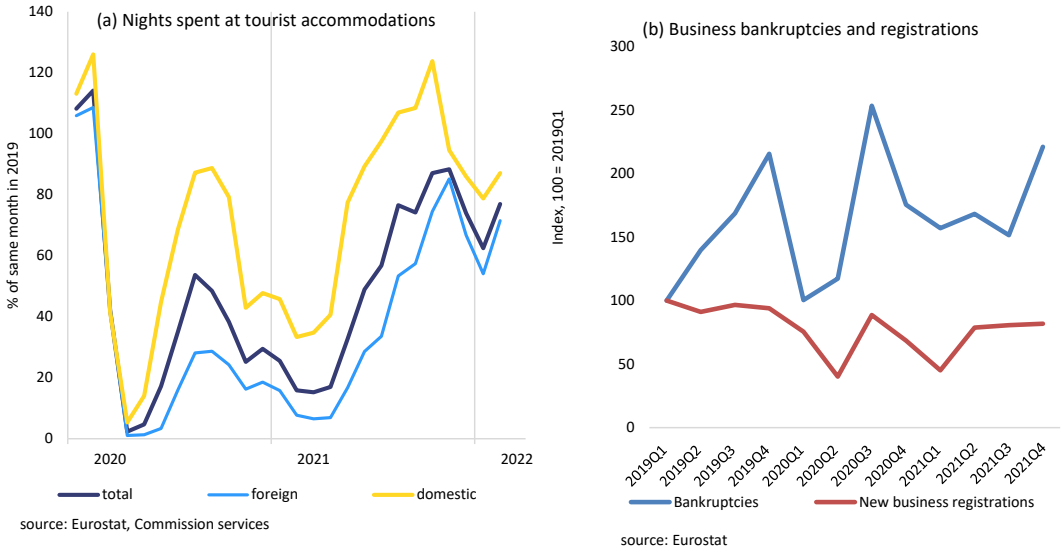
Source: European Commission services

Graph 3.2: **NIIP projections**



Scenario 1 (optimistic): assumes slightly higher GDP growth (+0.3 pp) and trade balance (+1 pp), e.g. as driven by stronger tourism performance than in the baseline. Scenario 2 (pessimistic): same as Scenario 1 but with an opposite sign.
Source: Commission services calculations

Graph 3.3: **Thematic Graphs: External Imbalances**



Source: European Commission services