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In-depth review for Portugal

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European Commission

Portugal

In-Depth Review 2023



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 – 2023 Spring Package" (COM(2023) 600 final) that:

Portugal continues to experience imbalances. Vulnerabilities related to high private, government and external debt are receding but remain present. After a temporary interruption due to the outbreak of the pandemic, private sector and government debt ratios returned to declining paths in 2021 and are expected to continue declining, favoured by economic growth While they are now below pre-pandemic levels, they remain at still elevated levels. The clearly negative NIIP improved too, both before and after the pandemic, and external indebtedness is projected to further recede, supported by continued economic growth despite some slowdown in 2023. The small current account deficit worsened marginally in 2022 reflecting higher energy prices but that deterioration was mitigated by the further marked recovery in exports, especially of tourism. Going forward, the assumed continued easing of energy prices and a further increase in tourism exports, as well as ongoing policies in support of energy efficiency and renewables, are projected to balance the current account and to further support adjustment in the NIIP. House prices have grown strongly for several years, while non-performing loans continued to decline from already moderate levels. The main risks to the further narrowing of vulnerabilities relate to the impact of the tightening of financial conditions and to an uncertain external environment, and their potential impact on economic growth. Policy progress has been favourable, with a particular focus on the RRP, and continuing implementing the RRP should deliver further improvements.

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1. INTRODUCTION

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalance Procedure (MIP), the Commission identified "macroeconomic imbalances" in Portugal. ([1]) These imbalances were related to high private, government and external debt in a context of low productivity growth. The 2023 Alert Mechanism Report published in November 2022 concluded that an in-depth review (IDR) should be undertaken also this year for Portugal with a view to assess the persistence or unwinding of imbalances. ([2]) The AMR concluded that in Portugal, concerns related to household and non-financial corporate, government and external debt-to-GDP ratios remained, although debt ratios resumed their declining path after the COVID-19 crisis. Nominal house price growth was accelerating, and signs of overvaluation of house prices had emerged. Risks associated with financial and public sector feedback loops remained.

Despite the difficult macroeconomic context, the Portuguese economy remains resilient, helped by a strong rebound in tourism. Portugal's GDP growth picked up from 5.5% in 2021 to 6.7% in 2022. ([3]) However, after a peak in the first quarter of 2022, growth slowed down in the following quarters as Russia's war of aggression against Ukraine further disrupted global supply chains. Portugal's growth picked up again in early 2023 but in full-year terms is expected to moderate to 2.4% in 2023 and 1.8% in 2024. The steep rise in global energy and food prices as well as country specific factors related to the severe drought until September 2022 pushed up headline inflation in Portugal from 0.9% in 2021 to 8.1% in 2022. Inflation is projected to gradually moderate in 2023-2024, helped by the assumed correction in energy prices over the period. The observed recovery in the country's water reservoirs is also expected to positively affect domestic energy and food markets. The current account is projected to improve over the forecast period supporting a further positive adjustment in the NIIP. The main risks to Portugal's economic outlook refer to the uncertain global environment and rising interest rates.

This in-depth review presents the main findings of the assessment of macroeconomic vulnerabilities for Portugal. The assessment is backed by a thematic section on external sustainability. Vulnerabilities related to housing and external balances in Portugal are also discussed in horizontal thematic notes that were already published. ([4]) The MIP assessment matrix is published in the 2023 Country Report for Portugal. ([5])

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

([2]) European Commission (2022), Alert Mechanism Report 2023, COM (2022) 381 final.

([3]) European Commission (2023), European Economic Forecast: Spring 2023, Institutional Paper 200.

([4]) European Commission (2023), Housing Market Developments: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 197. European Commission (2023), External Sustainability Analysis: Thematic Note to Support In-Depth Reviews, European Economy: Institutional Papers, 196.

([5]) European Commission (2023), Country Report Portugal 2023, SWD(2023) 622 final.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Gravity, evolution and prospects

On 5 April 2023 the Commission presented a horizontal thematic note on external balances, which also covered Portugal. It showed that Portugal experienced only a comparatively mild worsening in external flows over recent years, reaching a moderate current account deficit. The deterioration in the trade balance related to energy price increases since mid-2021 has been to a large extent offset by the recovery in the travel balance and in real terms exports have grown faster than imports since the start of 2022.

The current account temporarily worsened in 2022 due to price effects, while net exports improved in real terms. The current account deficit widened from 0.8% of GDP in 2021 to 1.3% in 2022, driven by exceptionally high prices of energy imports. In real terms, exports grew much faster than imports mainly due to the strong recovery in tourism, which moved close to its pre-pandemic level in 2022 after a steep contraction in 2020 and a partial recovery in 2021. Calculations eliminating the price effects in foreign trade, based on a simulation with terms of trade equal to zero, show that the current account would have posted a surplus of 0.3% of GDP that is close to the estimated country specific norm.

Portugal's negative net international investment position (NIIP) improved substantially both over time and since the pandemic, but remains significant. After a temporary deterioration in 2020, driven by the negative impact of COVID-19, the NIIP improved markedly for a second year in a row from -104.6% of GDP at the end of 2020 to -95.0% at the end of 2021 and to -83.9% at the end of 2022. A substantial part of this improvement resulted from the strong rebound in nominal GDP growth and favourable valuation changes while the overall net flow in the current and capital accounts had a slightly negative impact on the NIIP. Over time, the NIIP has strengthened by 40 percentage points of GDP, from -123.8% of GDP in 2014.

Going forward, the NIIP is projected to retain a sound pace of improvement. According to the Commission 2023 spring forecast, which incorporates the observed correction in energy prices after their peak in 2022, the current account is projected to improve substantially in 2023-2024 and the overall net flows in the current and capital accounts are set to turn positive. The NIIP to GDP ratio also benefits from continuously strong nominal GDP growth, despite the expected slowdown in real growth. In addition, the current and capital accounts, and consequently the NIIP, continue to benefit from the stream of Recovery and Resilience Plan (RRP) grants until 2026, estimated at around 6% of the country's 2022 GDP. Overall, the NIIP share in GDP is expected to improve to around -71% of GDP by the end of 2024 and to move above the country's estimated prudential threshold of -55% over a period of 10 years (see section 3). Risks to the country's external position are further mitigated by the favourable NIIP structure, as non-defaultable instruments account for around 60% of net liabilities and are composed mostly of foreign direct investments (FDI). As of end-2021, NENDI (NIIP net of non-defaultable instruments) in Portugal stood at -36.1% of GDP and further improved to -29.4% at the end of 2022.

Productivity in 2022 returned above its pre-pandemic level. Labour productivity, defined as real GDP per employee, improved in 2021-2022 following a drop reflecting the pandemic-driven contraction in tourism in 2020. The economy expanded much faster than employment with significant productivity gains recorded in tourism and manufacturing. In addition, exports rose faster than Portugal's export markets, resulting in an increase in the export market share in volume terms by 2.8% in 2021 and 11.9% in 2022. In cumulative terms, Portugal's exports outperformed the growth in markets since the last pre-pandemic year of 2019 and productivity in terms of real GDP per employee in 2022 was also higher than in 2019. Unit labour costs increased by 1.5% in 2022. The contribution of total factor productivity to potential growth improved to 1.5% in 2022 and is projected to remain close to this level over the forecast period. Meanwhile, potential growth is projected to improve to 2.0% in 2023 and 2.1% in 2024, exceeding the euro area average and performing better than before the pandemic, also helped by the projected positive impact of the RRP.

Private indebtedness continued to decline (Graph 2.1**a)**. Following a one-off increase in 2020 due to the pandemic driven economic contraction, the share of private debt in GDP has continued its downward adjustment. Helped mainly by the strong nominal growth in GDP, the debt ratio fell from 157% at the end of 2021 to 143% at the end of 2022. The ratio thus moved below its pre-pandemic level of 149% at the end of 2019 and well below the peak of 211% in 2012. Both corporates and households contributed to the decrease in the overall private sector indebtedness in 2022 but the ratios remained beyond the estimated country-specific prudential and fundamentals-based benchmarks ([6]). For corporates, these benchmarks were estimated at 65% and 59%, respectively, and for households at 41% and 30% (Graph 2.1c and 2.1d). Vulnerabilities in the debt structure, particularly in the corporate sector, declined in 2022 as risks related to the phase-out of state-support measures imposed during the pandemic did not materialise and the ratio of NPLs continued to decline. In addition, households' and corporates' deposits increased faster than loans in 2022, continuing the tendency from the previous two years and providing the private sector with a liquidity buffer. With the projected growth in nominal GDP in 2023-2024 and the recent moderation in net lending, the private debt ratio is set to decline substantially towards the country's prudential threshold.

The banking sector proved resilient over 2022, as profitability increased and non-performing loans continued to decline amid high uncertainty. The financial position of Portuguese banks did not face major setbacks from the phase-out of most pandemic support programmes. Asset quality remained sound despite the negative impact of the energy crisis and high inflation while risky loans declined over 2022, with Stage 2 loans decreasing from 11.6% to 10.3% and Stage 3 loans dropping from 3.7% to 3%. Banks continued reducing NPLs on their balance sheets, thanks to NPL sales and write-offs, supported also by low insolvency rates. This lowered the NPL ratio to 3.2% at the end of 2022, down from 3.6% at end-2021 and well below pre-pandemic levels (6.1% at end-2019). The NPL coverage ratio remained stable at 54%, even as banks released some of the impairments booked during the pandemic. In parallel, profit margins increased substantially, pushed up by higher key ECB interest rates and low deposit costs, which boosted banks' net interest income. This allowed banks to record their highest return on equity since the great financial crisis, i.e., 8.8% in 2022. Despite these positive developments, the financial sector continues to face uncertainty, as higher interest rates are increasing the pressure on the debt-servicing capacity of some borrowers.

([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. Methodologies are described in European Commission (2017) and updates to the methodology have been subsequently proposed in European Commission (2018).

On 5 April 2023 the Commission presented a horizontal thematic note on housing market developments, which also covers Portugal. It shows that house prices have increased substantially over the past decade but overall there are no major financial stability concerns in Portugal thanks to appropriate and sufficient macroprudential policies as assessed by the European Systemic Risk Board (ESRB, 2022, see also Box 1). In nominal terms, house prices had been growing at around 13% in the first three quarters of 2022 relative to a year earlier, but the growth rate softened to 11.3% in the last quarter of the year (graph 2.1e). In full-year terms, house price growth picked up from 9.4% in 2021 to 12.6% in 2022. However, the deflated house price index, adjusted by the private consumption deflator, slowed downed from 7.9% in 2021 to 5.9% in 2022. Accordingly, the valuation gap, estimated at 19.9% in 2021, widened to 24.2% in 2022. As of June 2022, outstanding mortgage loans accounted for 24.9% of Portuguese banks' total assets, staying on a declining trend (Graph 2.1f). Feedback loops between new mortgages and increasing house prices did not appear to be significant, as the share of mortgages among the value of new house transactions remained moderate, at 52% in March 2022, also thanks to the prudent loan-to-value ratios applied by banks. Furthermore, the increase in mortgage lending remained below the corresponding increases in GDP, house prices and household deposits.

Box 1: House price developments in Portugal

Over the last decade, house prices in Portugal have doubled in nominal terms with the last three years, 2020 to 2022, witnessing an increase of around 34%. These increases came after a fall in house prices of around 13% between 2008 and 2013, reflecting the global financial crisis and the sovereign debt crisis in Portugal. With the resumption of economic growth, house prices started to rise and house price growth has exceeded income growth since 2015, with a marked acceleration since the pandemic. As a result, the house price-to-income ratio is now 50% higher than a decade ago and is considerably above the peak it had reached before the onset of the global financial crisis. House prices are estimated to be overvalued by more than 20%. The recent increases were driven by a combination of low interest rates, construction supply constraints during the pandemic and rising construction costs. House price indices in popular tourism areas also reflect the increasing use of residential property for commercial purposes, helped by the rapid expansion of online short-term rental platforms, while foreign investors have also been active.

Housing affordability has deteriorated over time, with the price-to-income ratio having increased substantially. The number of years of income needed to buy a 100m2 apartment increased to 9.1 in 2022. However, the high share of home ownership mitigates related risks and households report a relatively low share of housing cost burden. Furthermore, significant foreign investments in properties have affected specific market segments that have very limited links to the disposable income of domestic households and the domestic banking system. Portugal has managed to gradually decrease the initially high level of household debt. The home ownership rate is high, with a moderate share of owners with a mortgage. Most of these mortgages are with a variable interest rate, which increases risks in a context of rising interest rates (Graph 2.1b).

The borrower-based macroprudential measures in Portugal, introduced in July 2018, set a number of important conditions on mortgage lending which affect housing prices. Such measures include limits to the loan-to-value (LTV) ratios (90% for own and permanent residence, 80% for other cases) and limits to the debt-service to income ratio (DSTI), capped at 50% for at least 85% of banks' mortgages. Moreover, a stress indicator for mortgages with variable rates was introduced. Limits to the duration of mortgages aim at reducing the average maturity of new agreements to 30 years. Overall, in February 2022 the European Systemic Risk Board (ESRB) found no major financial stability concerns related to house prices in Portugal thanks to the appropriate and sufficient macroprudential policies.

House price growth is expected to moderate going forward, as interest rates are on the rise. Certain supply constraints will continue to exist and reduce the scope for a substantial reduction in house prices in a context of strong property demand by foreign investors. The borrowing capacity of most households is set to decrease somewhat due to high house prices, high mortgage rates and a deterioration of real incomes in 2022, with high inflation also putting pressure on households' abilities to meet their mortgage payments. House prices are projected to continue growing, but at a lower rate, with a marked reduction of housing prices being unlikely. Wages are projected to rise faster than house prices in 2023-2024, supporting housing affordability.

Portugal's public debt-to-GDP ratio further decreased in 2022, while remaining above 100%. After reaching a peak of 134.9% in 2020, the Portuguese public debt-to-GDP ratio resumed its downward path contracting to 125.4% in 2021 and 113.9% in 2022, already below pre-pandemic levels. This decrease mostly reflects the favourable nominal growth-interest rate differential. While real GDP growth in 2022 was strong, the public debt-to-GDP ratio benefited in particular from the higher inflation and therefore higher GDP deflator. At the same time, interest expenditure decreased in 2022. This was coupled with a debt-reducing primary balance effect, reflecting the improvement in the general government deficit in 2022 to 0.4% of GDP, starting from 2.9% of GDP in 2021. The public debt-to-GDP is projected to further decline in 2023 and 2024, to 106.2% and 103.1%, respectively.

Public debt-to-GDP ratio remains vulnerable to a worsening of economic and financing conditions. According to the Commission's assessment Portugal faces high fiscal sustainability risks over the medium term and low ones over the long term, mostly due to the projected adverse demographic trends driving up ageing-related costs. In the long-term, fiscal sustainability risks are expected to ameliorate and are classified as low ([7]). Different country-specific factors mitigate these risks, including Portugal's comfortable cash buffer, the maturity structure of its debt, mostly with fixed rates, the stable financing sources, the debt's currency denomination as well as the debt management strategy targeting the smoothing of the debt redemption profile. Several factors add certain risks, such as the size of contingent liabilities linked to publicly guaranteed credit lines, ongoing processes on public-private partnerships (PPPs) financial rebalancing requests and upward pressure on current expenditure, particularly on public wages and social benefits.

Assessment of MIP relevant policies

Portugal continued implementing policies in all areas of its macroeconomic vulnerabilities, with a focus on policy commitments set under the country's RRP. The Commission's positive assessment of Portugal's second payment request acknowledges the continuation of the reform momentum in key policy areas such as the digital transition, including training and upskilling, reforms and investments related to health and social policies, the green transition and climate adaptation such as bioeconomy, sustainable transport and forest management and support of companies through the use of financial instruments. Reform progress under the first RRP payment already included, among others, important measures in support of industrial decarbonisation and production of renewable hydrogen. The external balance is expected to continue benefitting from RRP measures going forward. In July 2022, Portugal also inaugurated a 880MW pump storage facility that is set to substantially improve the utilisation of renewable energy and to reduce import needs in peak consumption periods with an overall positive impact on the external trade balance. Policy actions related to energy efficiency, the green transition and decarbonisation are expected to continue playing a significant role in reducing the country's net energy imports, which were the major factor behind Portugal's negative trade balance in 2022.

Several policy measures were taken in support of Portugal's export base and productivity. Specific actions, which are being implemented, refer to the digital transformation and business environment with the entry into force of the review of training content in the field of digital skills and the legislation for the creation of digital signatures. Furthermore, authorities launched the digital academy and employment programmes with the aim to increase the digital skills of employees and managers with a particular focus on enterprises in the industry, commerce,

([7]) See the DSA in the Commission Country Report 2023 for the latest risk classification and Debt Sustainability Report 2022 (April 2023) for methodological details.

services, tourism and agriculture sectors. Investments are expected to contribute to the development of lifelong vocational skills and training practices and to improve the ability of companies to face challenges and seize the opportunities brought by technology. In the area of bioeconomy, authorities approved projects for the development of new products, technologies and processes. This investment will provide financial support for integrating bio-based resources in traditional sectors of the Portuguese economy such as textile and clothing, footwear and natural resin. The aforementioned measures, many of which are in the process of implementation, are expected to improve Portugal's potential growth and consequently to support the financial deleveraging.

Portugal introduced new measures for boosting liquidity and capital to companies, supporting private investment and productivity. The state-owned promotional bank, Banco Português de Fomento (BPF), was set up in 2020. Since then, the bank issued a wide range of funds and guarantee lines to support companies in vulnerable sectors, as well as to address the issue of undercapitalisation of the Portuguese corporate sector. The Portuguese RRP includes a EUR 250 million recapitalisation of BPF as well as of two funds, managed by BPF, to provide over EUR 1.43 billion of equity and quasi-equity support to companies. These funds were set up in 2021 and issued first financing to the eligible companies in 2022. These measures support the development of equity markets in Portugal, promote better management of non-financial corporations and indirectly mitigate risks of insolvencies following the expiration of most pandemic-related support schemes.

Measures were taken to prevent developments in house prices that pose risks to the banking sector. In particular, the central bank adopted a macroprudential recommendation, lowering as of 2023 the average maturity for mortgage-backed loans to 30 years. This came on top of existing macroprudential measures that, as of Q2-2022, have been successful in bringing down the maximum loan-to-value ratio of new mortgages to 90% and the median loan-to-value ratio of outstanding mortgages to 51%.

The government approved a draft programme targeting the Portuguese housing market (*Programa Mais Habitação*) in February 2023, with a draft Law proposal pending discussion and approval in the Portuguese Parliament. This programme includes measures such as the elimination of the residence-by-investment scheme, also known as Golden Visa, a simplification of licensing processes, and fiscal incentives aimed at boosting housing supply. An income support for rents and a relief for the interest payments arising from housing loans was already introduced in March 2023 ([8]), with an estimated budgetary cost of 0.2% of GDP in 2023. These measures could contribute to alleviate immediate payment difficulties of households. The draft programme comes on top of restrictions to the Golden Visa scheme introduced already in 2022 with the aim of reducing demand for real estate, particularly in areas with the highest property price increases. As a result, real estate investments in the cities of Lisbon and Porto as well as in popular coastal areas are not eligible for residence-by-investment permits anymore.

The full implementation of planned fiscal-structural reforms are key to strengthen Portugal's medium-term fiscal sustainability. The full and effective implementation of the 2015 Budgetary Framework Law, subject to recurrent delays, would provide for a stronger budgetary framework, which is instrumental to improve the quality and composition of Portugal's public finances. Reforms under the RRP are targeted at spending efficiency and appropriate budgeting, including through spending reviews and the development of programme budgeting.

([8]) While the relief for interest payments is set to expire in 2023, the income support for rents is to be in force until December 2028. Decree-Law No 20-B/2023 of 22 March published in the Portuguese Official Journal ('Diário da República'), No 58/2023, first supplement, first series of 22 March 2023, pages 32-40.

Vulnerabilities persist in the financial sustainability of the National Health Services and in some state-owned enterprises, but relevant steps have been undertaken to enhance their governance, transparency and efficiency. New management contract templates entered into force for the public management of state-owned enterprises in December 2021 and national health services in June 2022. On the other hand, Portugal has made limited progress in improving the effectiveness of the tax and social protection systems where there is scope to simplify both frameworks, to strengthen the efficiency of their respective administrations, and to reduce the associated administrative burden.

Conclusion

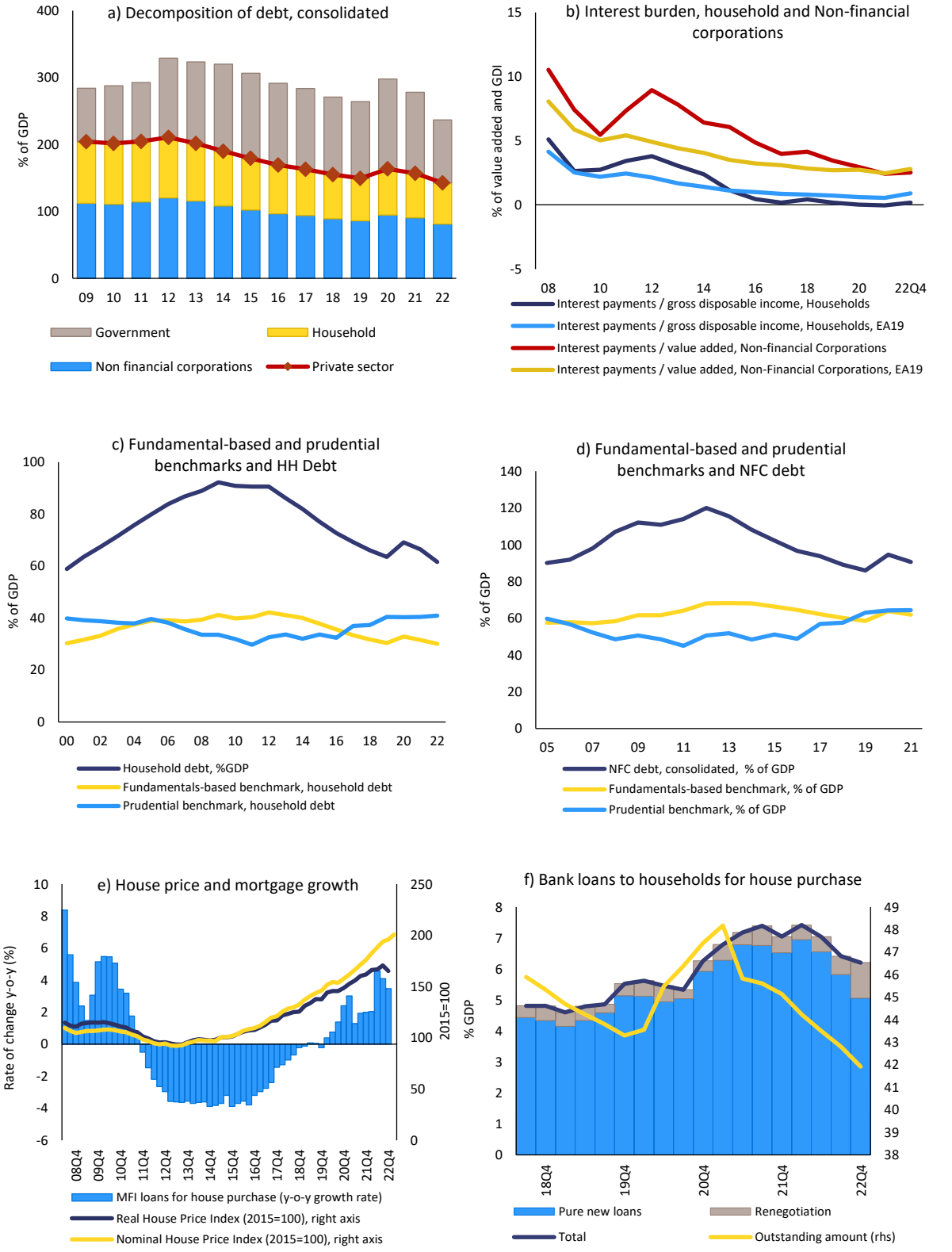
In Portugal, vulnerabilities related to the high level of public, private and external indebtedness, which continue to recede. After a temporary interruption due to the outbreak of COVID-19 in 2020, Portugal returned on a steady path of adjusting its macroeconomic vulnerabilities amid high uncertainty in the global environment. Both public and private debt ratios improved substantially in 2021 and 2022 to levels below those in the pre-pandemic period, but remain substantial ad need to correct futher. According to the Commission's assessment, Portugal's fiscal sustainability risks are considered high over the medium term and low in the long term. The ratio of the country's NIIP relative to GDP improved substantially, helped by strong economic growth. A substantial part of the NIIP is composed of non-defaultable debt instruments and NPLs continued to decline. Productivity also improved with substantial gains in tourism and manufacturing. Going forward, the country's indebtedness is projected to continue its favourable trajectory supported by economic growth. Although real GDP growth is forecast to weaken temporarily in 2023, nominal GDP is still expected to continue to rise at a relatively high rate due to the projected high GDP deflator. In the external sector, the assumed correction in energy prices and a further increase in foreign tourism revenues are set to balance the current account and to further support the strong pace of adjustment in the NIIP position. Further on, the country's external position and overall economic outlook are set to continue to benefit from RRP grants until 2026, and the NIIP is set to further correct. The main risks relate to unwinding of macroeconomic vulnerabilities refer to the uncertain external environment and its potential impact on Portugal's economic growth.

Policy progress in response to the identified vulnerabilities has been made, with a particular focus on the ongoing RRP implementation. The ongoing implementation of Portugal's RRP is expected to continue having a significant impact on the country's energy efficiency, production of renewables and its export potential that will ultimately support the country's external position. The ongoing RRP implementation is also expected to support the country's productivity through investments in digital technologies and skills as well as liquidity and capitalisation of vulnerable firms. The authorities also took steps in 2022 to address issues related to housing affordability resulting from the continuous growth in house prices. The full implementation of planned fiscal-structural reforms are key to strengthen Portugal's medium-term fiscal sustainability. Portugal has made limited progress in improving the effectiveness of the tax and social protection systems.

Based on the findings in this in-depth review, the Communication "European Semester – 2023 Spring Package" sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Portugal, in line with Regulation 1176/2011. ([9])

([9]) European Commission (2023), European Semester Spring Package 2022, COM(2023) 600 final.

Graph 2.1: **Selected graphs, Portugal**



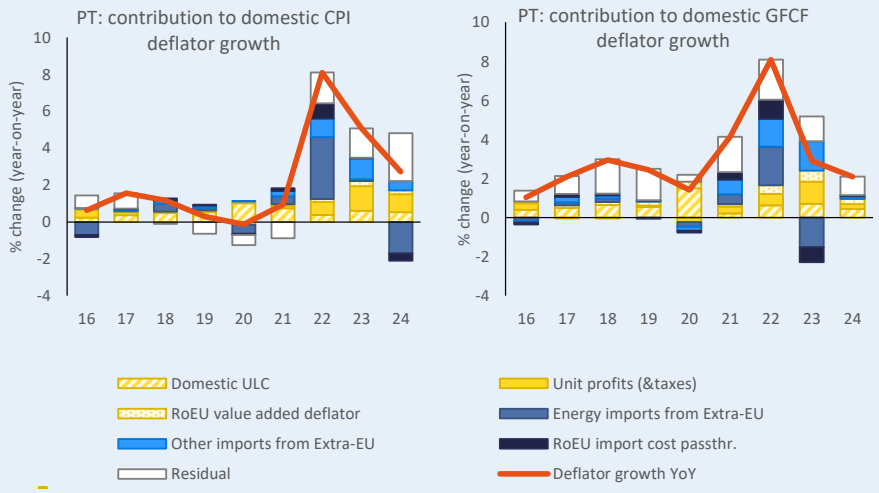
Source: European Commission services

Box 2: Inflation exposures and cross-border pass-through

This box sheds light on the sources of inflation in Portugal and its spill-overs with EU partners. The period since 2021 has been characterized by pandemic aftershocks and global supply chain disruptions compounding global inflationary pressures and a surge in commodity prices triggered by Russia's war of aggression against Ukraine. As a result, inflation in Portugal surged to unprecedented levels. In response, wages and profits also picked up across the EU, which further added to price pressures in Portugal. With input-output data, domestic inflation can be decomposed into the contributions from key cost factors. Taking into account some data limitations, the framework can be used to attribute consumer and investment price changes to i) extra-EU import price changes, which include both directly imported inflation and inflation passed through from EU partners import costs ii) domestic unit labour cost changes iii) domestic unit profit changes, including indirect taxation changes and iv) rest-of-EU value added price changes. ([10])

Data suggests that inflation in Portugal increased strongly on account of imported inflation in 2022, whereas the importance of domestic drivers is expected to increase in 2023. In 2022, as shown in Graph 2.2, energy prices were a key inflationary factor. In addition, prices of non-energy imports from outside the EU also contributed to the acceleration of consumer and investment inflation. Inflation spill-overs from other EU countries as well as domestic value added inflation contributed mildly. Subsiding energy imports inflation is set to ease domestic inflation considerably in 2023 and 2024. By contrast, prices of non-energy imports are expected to sustain consumer and investment inflation this year. In addition, domestic value added inflation is set to increase its contribution to both consumer and investment inflation. Both unit profits and unit labour cost are expected to increase at a higher pace compared to 2022. Spill-overs from value added inflation in other EU partners is also set to increase investment inflation somewhat in 2023.

Graph 2.2: **Components of gross fixed capital formation deflator growth and consumer price inflation**



Source: European Commission services

([10]) The graphs below are based on national accounts data and the Commission's Spring 2023 forecast, combined with Eurostat input-output data. HICP is taken as the measure of the price of private consumption, including non-residents. Changes in import prices and value-added deflators are assumed to affect demand prices with a delay of 5 months for both, consumption and investment inflation. For further methodological details, see explanations in the 2023 in-depth review for Czechia, p. 16.

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

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	2024
Real GDP	1.1	-1.4	1.7	2.7	-8.3	5.5	6.7	2.4	1.8
Potential growth (1)	1.0	-0.4	0.6	1.7	1.3	2.0	1.8	2.0	2.1
Contribution to GDP growth:									
Domestic demand	1.0	-2.8	1.7	3.4	-4.9	5.5	4.6	1.4	1.9
Inventories	0.1	-0.1	0.1	-0.3	-0.5	0.3	0.0	0.0	0.0
Net exports	-0.1	1.5	-0.2	-0.4	-3.0	-0.2	2.0	1.0	-0.2
Contribution to potential GDP growth (1):									
Total Labour (hours)	-0.3	-1.1	0.3	0.4	0.2	0.5	0.2	0.5	0.6
Capital accumulation	0.9	0.3	-0.2	0.1	-0.1	0.1	0.1	0.1	0.2
Total factor productivity	0.4	0.4	0.5	1.2	1.1	1.4	1.5	1.4	1.3
Output gap (2)	-1.2	-1.7	-1.3	3.1	-6.6	-3.4	1.3	1.7	1.3
Unemployment rate	8.6	12.6	12.1	6.7	7.0	6.6	6.0	6.5	6.3
Harmonised index of consumer prices (HICP)	2.7	1.9	0.7	0.3	-0.1	0.9	8.1	5.1	2.7
GDP deflator	3.1	0.6	2.0	1.7	2.0	1.5	4.4	5.8	2.3
External position									
Current account balance (% of GDP), balance of payments	-8.8	-8.0	0.8	0.4	-1.0	-0.8	-1.3	1.1	1.0
Trade balance (% of GDP), balance of payments	-7.5	-5.4	1.3	0.8	-1.9	-2.6	-2.1	.	.
Primary income balance (% of GDP)	-1.9	-3.2	-2.2	-2.4	-1.4	-0.8	-1.5	.	.
Secondary income balance (% of GDP)	0.7	0.6	1.7	2.0	2.3	2.6	2.2	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-1.5	-0.9	-0.3	-0.2	-0.1	-0.2	-0.2	-0.1	-0.1
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-0.5	0.6	-1.0	-0.8	-1.4	-1.1	-0.6	-0.4	-0.4
Capital account balance (% of GDP)	1.5	1.5	1.2	0.9	1.0	1.7	0.9	.	.
Net international investment position (% of GDP)	-73.7	-107.8	-115.0	-100.0	-104.6	-95.0	-83.9	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-41.3	-71.3	-67.7	-46.7	-46.7	-36.5	-29.4	.	.
Net FDI flows (% of GDP)	0.3	-2.4	-2.9	-3.6	-2.5	-3.4	-2.0	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	1.8	-0.2	0.8	2.8	8.7	0.6	1.5	3.7	1.7
Nominal compensation per employee	3.3	0.4	1.5	4.8	1.5	4.1	6.1	5.7	2.9
Labour productivity (real, hours worked)	1.4	1.1	0.2	1.5	0.3	2.4	3.6	1.0	0.5
Real effective exchange rate (ULC)	0.1	-1.9	-0.4	0.6	3.8	0.3	-1.6	-1.5	-1.5
Real effective exchange rate (HICP)	1.4	-0.5	0.0	-1.7	0.2	-1.7	-1.4	.	.
Export performance vs. advanced countries (% change over 5 years)	5.2	-3.3	3.7	6.5	-1.0	-0.8	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	171.2	203.4	176.4	149.5	163.7	157.0	142.7	.	.
Household debt, consolidated (% of GDP)	79.5	90.6	75.5	63.5	69.1	66.4	61.5	.	.
Household debt, fundamental benchmark (% of GDP) (6)	12.1	17.7	27.9	31.0	32.6	31.2	31.1	.	.
Household debt, prudential threshold (% of GDP) (6)	39.1	39.2	37.2	33.6	33.6	31.9	29.7	.	.
Non-financial corporate debt, consolidated (% of GDP)	91.7	112.8	100.9	86.0	94.6	90.6	81.1	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	40.4	40.1	47.0	50.4	53.3	53.3	55.4	.	.
Corporate debt, prudential threshold (% of GDP) (6)	52.9	53.7	55.5	48.6	50.6	48.5	45.6	.	.
Private credit flow, consolidated (% of GDP)	12.6	4.4	-1.4	2.6	4.4	4.1	2.8	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-4.0	-1.7	2.8	-0.9	0.4	0.4	-0.7	1.2	1.2
Households, net lending (+) or net borrowing (-) (% of GDP)	1.6	3.0	2.5	1.8	5.2	3.4	0.5	1.0	0.7
Net savings rate of households (% of net disposable income)	2.6	1.5	-1.2	-2.2	2.1	-0.6	-5.4	.	.

(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 halve the gap between the NIIP and the indicative MIP benchmark of -35% of GDP over the next ten years, or to stabilise the NIIP at the current level if it is already above the indicative MIP benchmark. 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: Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

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

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Housing market									
House price index, nominal	1.5	-1.7	5.3	10.0	8.8	9.4	12.6	.	.
House price index, deflated	-1.8	-2.9	4.2	9.0	8.1	7.9	5.9	.	.
Overvaluation gap (%) (7)	-1.5	-2.6	-9.2	6.5	13.8	19.9	24.2	.	.
Price-to-income overvaluation gap (%) (8)	-1.5	-9.2	-10.2	4.1	14.7	20.9	26.2	.	.
Residential investment (% of GDP)	5.8	3.7	2.7	3.2	3.4	3.8	4.0	.	.
Government debt									
General government balance (% of GDP)	-5.0	-7.8	-3.7	0.1	-5.8	-2.9	-0.4	-0.1	-0.1
General government gross debt (% of GDP)	69.9	101.4	129.1	116.6	134.9	125.4	113.9	106.2	103.1
Banking sector									
Return on equity (%)	13.8	0.3	-5.2	2.0	-1.7	4.2	.	.	.
Common Equity Tier 1 ratio	6.7	8.1	12.2	14.7	15.5	14.9	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	1.2	4.1	11.5	4.9	3.9	3.0	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	14.8	6.1	4.9	3.6	3.2	.	.
Cost of borrowing for corporations (%)	5.1	5.6	3.4	2.2	2.0	2.0	4.4	.	.
Cost of borrowing for households for house purchase (%)	4.0	3.6	2.2	1.1	0.8	0.8	3.3	.	.

(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: Source: Eurostat and ECB as of 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

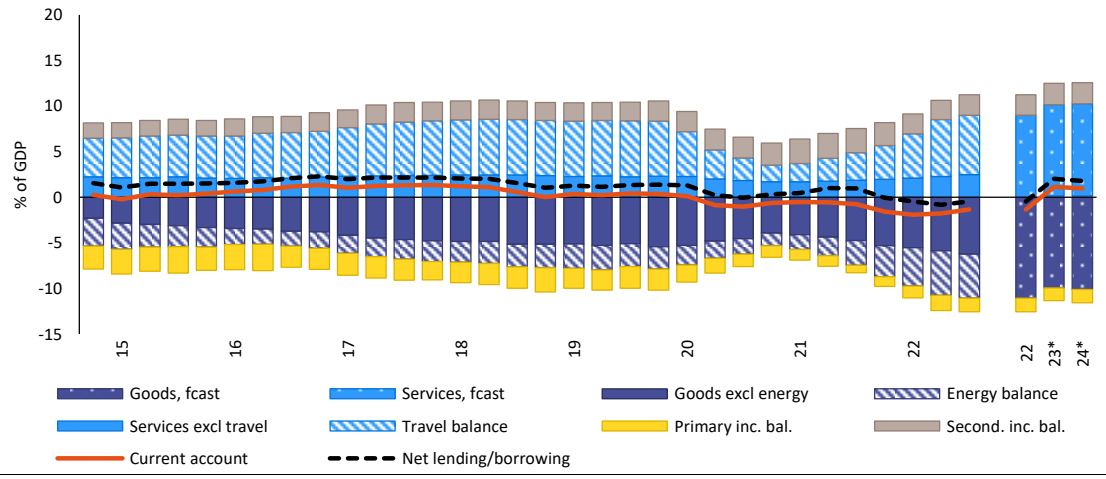
3. THEMATIC CHAPTER: EXTERNAL SUSTAINABILITY

On 5 April 2023 the Commission presented a horizontal thematic note on external balances, which also covers Portugal. The note covers information available until the third quarter of 2022 and forwarding-looking perspectives based on the Commission 2022 autumn forecast. This thematic chapter aims at updating the analysis with full-year data for 2022 and with a forward-looking perspective based on the Commission 2023 spring forecast. It also expands the country's coverage in the horizontal note by more detailed analysis of the impact of energy and tourism on Portugal's current account balance in 2022 and the role of these two sectors for the overall external balance performance over the forecast period.

Prior to the start of the COVID-19 pandemic in early 2020, Portugal had achieved a significant adjustment in the current account, moving from very large deficits until 2011 to small surpluses in the period of 2013-2019 (graph 3.1**)**. The current account however reversed to a small deficit of 1.0% of GDP in 2020 due to the pandemic-driven shock to the country's large tourism sector (graph 3.3d). In the same year, net travel receipts in the Portugal's balance of payments contracted to 2.5% of GDP relative to 6.1% in the previous year. This coincided with a temporary loss in export market shares (graph 3.3c) and an appreciation in the real effective exchange rate based on unit labour costs (graph 3.3b). With the gradual relaxation of travel restrictions, the tourism sector started to recover. The current account moved slightly up to -0.8% of GDP in 2021 but then it worsened again to -1.3% in 2022. This raised concerns about the sustainability of Portugal's external flows in the context of the uncertain global environment.

A closer look at the factors behind the deterioration in the current account show that it has been driven by temporary factors. In 2021, these were still related to the remaining travel restrictions as net travel receipts recovered only slightly to 3% of GDP. In addition, the country's balance was adversely affected by price effects as the terms of trade deteriorated by 1.2%. In 2022, tourism revenues recovered substantially in real terms and in nominal terms they exceeded the pre-pandemic level, as net travel receipts reached an all-time high of 6.5% of GDP. However, the country's overall trade balance faced a very substantial negative price impact during the year, particularly from energy commodities, leading to an overall deterioration in the terms of trade of 3.3%. Calculations show that when eliminating the price effects, that is under a simulation with neutral terms of trade, the current account would have posted a surplus of 0.3% of GDP. This is also illustrated by the positive trade dynamics in real terms where exports of goods and services grew faster than imports with an overall net contribution of two percentage points to the GDP growth of 6.7% in 2022.

Graph 3.1: **Current account, tourism and energy balance, Portugal**



Source: Ameco, Comext, Eurostat, European Commission calculations

In addition to the negative price effects in 2022, Portugal's trade balance was adversely affected by the severe drought in Portugal until September 2022, leading to exceptionally low hydropower generation (graph 3.3**a).** The share of hydropower in Portugal's total power generation fell to 15% in 2022 from 23% in the previous year and in volume terms was 37% below the long-term annual average. This increased the country's needs for electricity imports and raised the use of natural gas imports for power generation at times when both electricity and gas prices were at record highs. According to data of Portugal's electricity and gas operator REN, electricity import volumes increased two-fold in 2022 and 11-fold relative to the annual average for the previous five years. Taking into account the spot prices of electricity and gas, the unfavourable hydro balance was responsible for at least half of the overall current account deficit in 2022. Overall, the aggregate impact of the drought and the price hikes across all energy imports widened Portugal's energy trade deficit to around 5% in 2022 relative to 2.7% in 2021 and an annual average of 2.3% in 2017-2021.

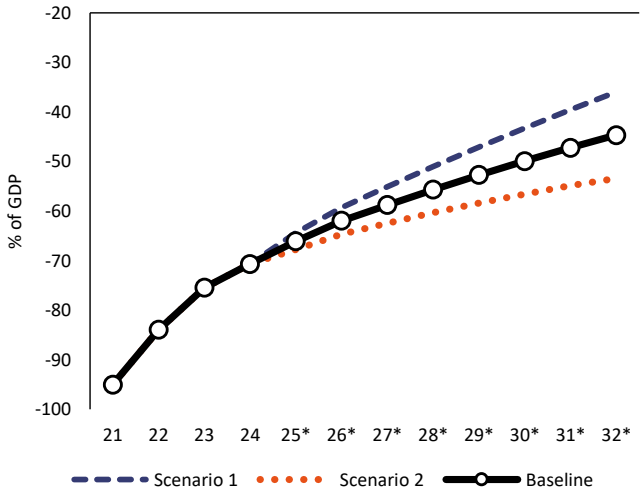
Going forward, several factors are expected to play a favourable role for Portugal's current account. The downward price correction of energy commodities, particularly for natural gas and electricity, is projected to improve significantly the terms of trade for Portugal in 2023. In addition, significant rainfalls since late 2022 raised the level of the country's hydro reservoirs above the long-term average rates. Consequently, Portugal's net imports of electricity declined by 55% (y-o-y) in the first quarter of 2023 and gas imports for electricity production declined by 39% for the same period. Portugal also inaugurated in 2022 a new hydro pumped storage facility with a power generation capacity of 880MW that will improve the capacity of the system operator to cover demand peaks by utilising domestic renewable energy from excess production periods, leading to lower import demand. Finally, the tourism indicators for 2023 also look favourable. According to the Commission 2023 spring forecast, the current account is expected to move to a surplus of 1.0% of GDP in 2023 and 0.8% in 2024. In the medium and long term, Portugal also has good prospects to reduce its energy trade deficit, which has been a major source of vulnerability for the overall current account balance in 2022. Ongoing projects in the area of energy efficiency, renewables and industrial decarbonisation, including RRP financed initiatives, are expected to further improve the country's external position.

Despite the current account deficit in 2022, Portugal's net international investment position (NIIP) improved substantially for a second year in a row (graph 3.3**e)**. The NIIP share in GDP increased from -104.6% of GDP at the of 2020 to -95.0% at the end of 2021 and -83.9% at the end of 2022. A substantial part of this improvement resulted from the strong rebound in GDP and favourable valuation changes (graph 3.3f). The overall net flow in the current

and capital accounts was slightly negative. As compared to the historical low of -123.8% of GDP in 2014, the NIIP improvement accounts for more than half of the deviation from the estimated country-specific prudential threshold of 50%.

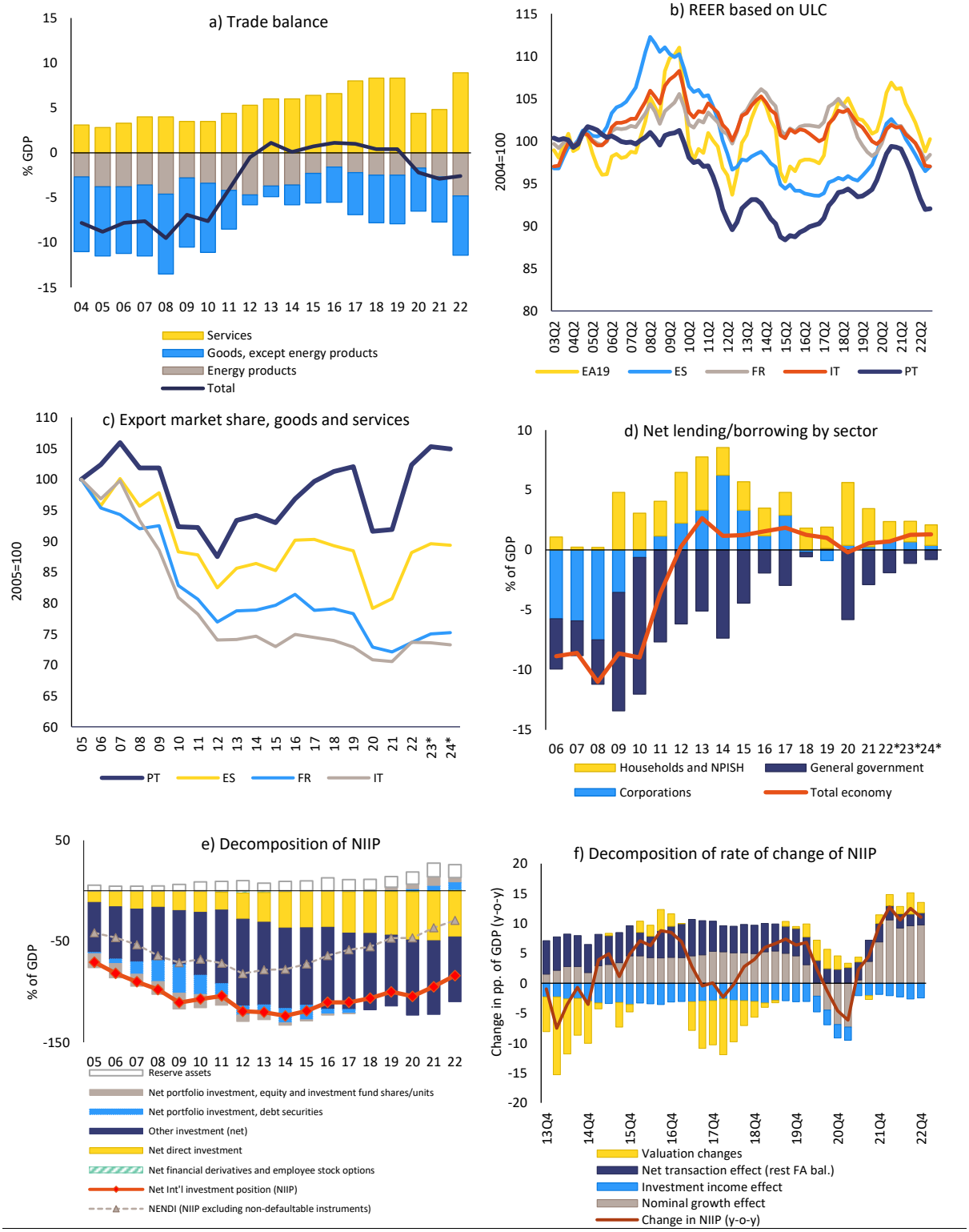
The NIIP is projected to continue improving at a sound pace (graph 3.2**)**. Under the baseline assumptions, the NIIP is estimated to move comfortably within the prudential threshold over a ten-year period to around -45% in 2032. Risks to the country's external position are further mitigated by the favourable NIIP structure, as non-defaultable instruments account for around 60% of net liabilities and are composed mostly of foreign direct investments (FDI). As of end-2021, NENDI (NIIP net of non-defaultable instruments) in Portugal stood at -36% of GDP, and improved further to -29% of GDP in 2022.

Graph 3.2: **NIIP projections**



(1) Scenario 1 (optimistic): assumes slightly higher GDP growth in 2025 (+1 pp) and trade balance in 2025 and beyond (+1 pp) than in the baseline. Scenario 2 (pessimistic): same as Scenario 1 but with an opposite sign.
Source: European Commission services

Graph 3.3: **Selected graphs, Portugal**



Source: European Commission services

Table 3.1:**Selected external indicators, Portugal**

	Source:	2003-07	2008-12	2013-17	2019	2020	2021	2022	2023f	2024f
Flows [1]										
CA balance as % of GDP, NA	*(b)*	**-9.4**	**-7.8**	**0.5**	**0.1**	**-1.2**	**-0.8**	**-1.5**	**1.0**	**0.8**
CA balance as % of GDP, BoP	*(a)*	-9.4	-8.0	0.9	0.4	-1.0	-0.8	-1.3	1.1	1.0
Cyclically adj. CA balance as % of GDP [2]	*(c)*	-10.6	-7.9	0.3	1.2	-1.8	-1.9	-0.4	2.5	1.9
CA req. to stabilize NIIP above -35% of GDP ove	*(c)*	-0.3	0.6	-1.0	-0.8	-1.4	-1.1	-0.6	-0.4	-0.4
CA explained by fundamentals (CA norm) [4],[8]	*(c)*	-1.4	-0.9	-0.4	-0.2	-0.1	-0.2	-0.2	-0.1	-0.1
Required CA for specific NIIP target [5]	*(c)*	0.4	2.3	1.4	0.6	0.1	0.4	0.9	1.1	1.1
Trade bal. G&S, % of GDP, NA	*(b)*	-8.0	-5.8	0.8	0.5	-2.1	-2.9	-2.5	0.1	0.0
Required TB for specific NIIP target [5]	*(c)*		2.2	0.6	-0.4	-0.8	-0.4	0.0	0.1	0.0
Stocks										
NENDI as % of GDP	*(a)*	**-44**	**-71**	**-70**	**-47**	**-47**	**-36**	**-29**		
of which: net portfolio debt	*(a)*	-4	-18	-9	1	2	5	8		
of which: net mutual fund shares	*(a)*	4	5	9	13	15	18	13		
of which: net other investment	*(a)*	-49	-65	-79	-70	-75	-73	-64		
NIIP as % of GDP	*(a)*	**-77**	**-108**	**-117**	**-100**	**-105**	**-95**	**-84**	**-77**	**-72**
Prudential NIIP/NENDI benchmark [8]	*(c)*	-53	-52	-51	-54	-52	-52	-55	-55	-56
Fundamentally expl. NIIP benchmark (NIIP nor	*(c)*	-13	-16	-21	-19	-20	-19	-19	-17	-16
Gen. Government NIIP	*(a)*	-43	-57	-77	-58	-64	-53	-43		
Private Sector NIIP	*(a)*	-15	-20	-36	-47	-52	-55	-53		
of which: Net FDI [6]	*(a)*	-11	-16	-28	-34	-37	-40	-38		
MFI (excl CB) NIIP	*(a)*	-43	-31	-8	-7	-2	0	0		
Oth. financials NIIP	*(a)*	15	3	6	13	16	18	13		
Central bank NIIP	*(a)*	10	-3	-2	0	-2	-6	-1		
of which: Reserves	*(a)*	5	8	10	10	12	13	13		
of which: Target2	*(a)*		-26	-36	-36	-40	-37	-29		
Value-added trade and capital account										
VA imports % of agg. demand [7]	*(d)*	29	29	30						
Capital account bal. as % of GDP, NA	*(b)*	1.4	1.4	1.2	0.9	1.0	1.7	0.9	1.0	1.0
Indicators in % of potential GDP					0.0	0.0	0.0	0.0	0.0	0.0
CA balance as % of potential GDP, NA	*(b,c)*	-9.3	-7.7	0.5	0.1	-1.1	-0.8	-1.5	1.0	0.8
CA balance as % of potential GDP, BoP	*(a,c)*	-9.3	-7.9	0.9	0.4	-1.0	-0.7	-1.4	1.2	1.0
Cyclically adj. CA balance as % of potential GDI	*(c)*	-10.5	-7.9	0.3	1.3	-1.7	-1.9	-0.4	2.5	2.0
Trade bal. G&S, as % of potential GDP, NA	*(b,c)*	-7.9	-5.7	0.8	0.5	-2.0	-2.8	-2.6	0.1	0.0
NENDI as % of potential GDP	*(a,c)*	-44	-70	-69	-48	-44	-35	-30		
NIIP as % of potential GDP	*(a,c)*	-76	-106	-114	-103	-98	-92	-85	-78	-73
Capital account bal. as % of potential GDP, NA	*(b,c)*	1.3	1.4	1.2	0.9	0.9	1.7	0.9	1.0	1.0

(f) European Commission forecast. (1) 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). (2) Quarterly data is annualized.

Sources: (a) Eurostat, (b) Ameco, (c) European Commission calculations, (d) ECB.