EthiFinance Ratings upgrades Portugal's rating to BBB+ with Stable outlook

- The European credit rating agency assumes that the Portuguese economy will grow by 2.7% by 2023, according to the European Commission's forecasts.
- The report highlights, once again, the favorable evolution of the Portuguese labor market, whose unemployment rate has fallen to 6.0% of the active population, and the convergence in terms of GDP per capita with the rest of the European partners.
- On the negative side, the rating is constrained by the high volume of public debt, which, although it has been corrected in recent years, remains at levels above 110%.

Unsolicited Rating of the Republic of Portugal

In its May review, EthiFinance Ratings upgrades the Republic of Portugal's unsolicited credit rating from BBB to BBB+ with a Stable outlook. The European rating agency considers that the Portuguese economy will grow by 2.7% this year, according to the European Commission's forecasts. This rating improvement is based on the "rapid" economic recovery during 2021 and 2022, as well as on the correction of certain imbalances in public finances and the financial system consolidation carried out last years. It also emphasizes the favorable evolution of the Portuguese labor market, which last year reduced its unemployment rate to 6% of the active population, seven tenths of a percentage point less than at the end of 2021. However, the rating is limited by the high level of public debt which, despite the downward trend observed in recent years, will be above 110% at the end of this fiscal year 2023.

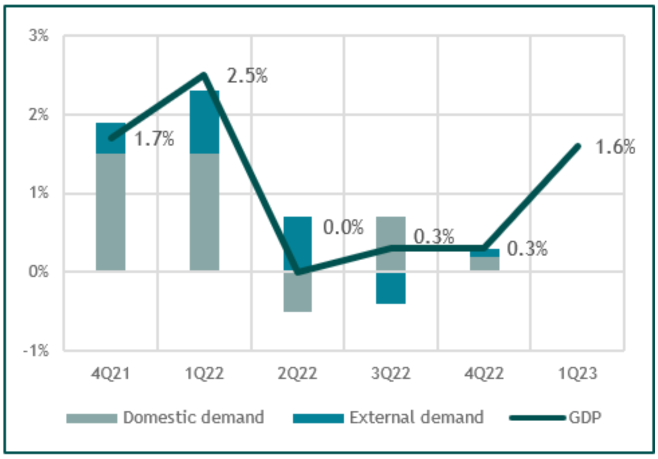
Madrid, May 22, 2023

In its May review, EthiFinance Ratings **upgraded the Republic of Portugal's unsolicited rating from BBB to BBB+ with a 'Stable' outlook**, due to the "rapid" recovery observed in fiscal years 2021 and 2022, as well as the correction of some of the imbalances in the public accounts and the consolidation of its financial system.

However, the rating report warns that both the credit rating and the outlook could worsen *"if inflationary pressures and tighter financing conditions persist"* or if there is *"a reversal of the fiscal consolidation"* of recent years resulting in higher deficit and public debt levels.

That said, the European rating agency highlights the growth of the Portuguese economy last year to 6.7% and 2.7% this year 2023, according to the European Commission's forecasts and 1.6 points above the EU-27 average. An advance in which, as already highlighted in last November's review, the progressive recovery of domestic demand - due to both the increase in public spending and the strengthening of household consumption -, the structure of the Portuguese electricity market - which has cushioned inflationary pressures -, the important weight of the services sector - with tourism as the main driver of economic growth - and the lower direct dependence on Russia and Ukraine have been decisive.

Figure 3. Quarterly GDP growth (quarter-on-quarter, % change)



Source: National Institute of Statistics of Portugal

The report warns of the uncertainty of the risk posed by inflationary pressures for the Portuguese economy, which is already showing a certain slowdown. The Portuguese CPI is estimated at 5.1% at the end of the year, falling to 2.7% in 2024.

In addition to the rise in prices, there are the measures implemented by the ECB in terms of monetary policy, with an increase in interest rates to 3.75% this May, which will undoubtedly have an impact on the real economy and the business fabric. This, together with the tightening of financing conditions, is *"one of the potential risks that could weigh on consumption and production this year".*

Once again, the BBB+ credit rating with a 'Stable' outlook positively assesses the strength of the Portuguese labor market, whose unemployment rate has been reduced to 6.0% of the labor force in 2022, seven tenths of a percentage point lower than at the end of the 2021 fiscal year. However, given the moderation in the rate of growth as well as an increase in the active population, this will rise to 6.5% in 2023, before falling back to 5.7% in 2024.

Likewise, EthiFinance Ratings continues to warn of the duality of the Portuguese labor market as the main weakness *"especially between skilled and unskilled people",* as well as the temporary nature of the labor market. Both factors represent *"a reduction in future growth potential and at the same time encourage the exodus of workers - mainly the youngest - to other European markets. This fact aggravates the demographic problem".*

Portugal's demographics, with negative natural growth in recent years, is precisely one of the factors that constrains the rating. The country also has a "high" dependency rate of 54.7% of the population between 20 and 64 years of age, with a tendency to worsen in the coming decades due to the decline in the birth rate and the increase in life expectancy to 81 years. "This is a challenge for the growth potential of the Portuguese economy, both because of the lower propensity to consume of people considered dependent, and because of the pressure that care spending will exert on public finances".

Regarding the external sector, Portugal is expected to recover its position as a net exporter to pre-pandemic levels, which, in addition, is supported by an increase in international investment flows.

Furthermore, as the European Commission announced, the country is expected to return to surplus positions by the end of the current fiscal year due to the improvement in the terms of trade of raw materials and the growth of tourism.

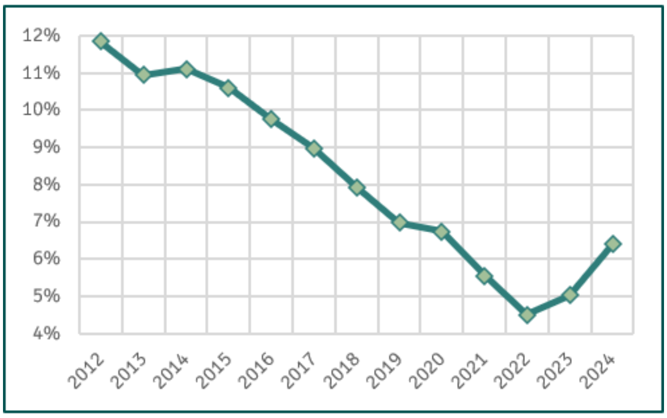
Public debt above 110% of GDP

The rating granted to the Republic of Portugal reflects the *"considerable improvement"* in the public finances of the Portuguese country which, in 2021, managed to correct the public deficit to -2.8% of GDP. This adjustment path continued last year, bringing the negative deficit down to -0.4% (one point lower than expected in the November review). For this year, this correction path is expected to be maintained at -0.1%.

EthiFinance Ratings explains that this progressive reduction in deficit levels *"is due to the good performance of revenue collection driven by both the rapid recovery of the Portuguese economy and the effect of rising prices".*

On the other hand, the report warns of the high levels of public debt. All this despite the reduction of almost 10 points, to 116% in 2022 and which will continue in 2023 when it is expected to contract by nearly another four points, to 112.4%. In addition, *"the rise in interest rates is positioned as a potential risk to the Portuguese debt profile through the cost of debt,"* the report notes.

Figure 5. Evolution of the cost of debt (interest over current revenues, %)



Source: AMECO

Monetary policy and financial system

Although EthiFinance Ratings considers that the successive interest rate hikes approved by the ECB to avoid entering an inflationary spiral *"are appropriate",* they warn that these *"pose a risk to the growth of euro zone countries",* including Portugal.

Nevertheless, the European credit rating agency positively assesses *"the favorable progress made by the Portuguese financial system in recent years".* In fact, it notes a significant reduction in the NPL ratio, from 6.2% in 2019 to 3.2% in November 2022. The above accompanied by an increase in profitability in both ROA (from 0.4% to 0.7%) and ROE (from 5.4% to 8.8%).

On the other hand, the report highlights that *"Portugal's financial system has proven to be resilient in terms of liquidity and solvency"*. With *"favorable"* positions and CET1 levels of 15.3% in 2022 *"well above those required by the ECB",* in terms of solvency. In addition, the Loan to Deposits ratio improved by three points (to 78%), which confirms the good health of the loan-to-deposit ratio of the Portuguese banking system.

ESG and institutional framework

Portugal registers one of the best governance rankings in the European Union and shows an adequate institutional framework that is recognized by its top position in the transparency and supervision and control rankings prepared by the World Bank. The latter places special emphasis on government efficiency and the control of corruption and violence in the country.

Likewise, the rating positively values the absolute majority obtained by Antonio Costa in the elections, since, despite the uncertainty generated by the latest controversies with President Marcelo Rebelo de Sousa, it does not consider the dissolution of the Portuguese government to be a material risk at the moment.

EthiFinance Ratings' rating methodology also incorporates ESG (Environmental, Social and Governance) principles. Despite improvement in recent years, Portugal remains below the European average in most social aspects and has not yet issued any sovereign green bonds.

In environmental terms the report notes Portugal's *"high exposure to the physical risks of climate change",* ranking 37th in Germanwatch's Global Climate Risk Index 2021. This could impact in different ways on public finances - through increased spending - and on the economy - mainly through labor and land productivity. Thus, *"adaptation to climate change in Portugal is a key issue in the medium term"*. Moreover, although the country has a high energy dependence (66.9% imported), its renewable energy production is significantly higher than the European average.

On the social aspect, the main limitation is the high level of inequality, with a GDP per capita of only 66% of the European average with a GINI index of 0.33 points compared to 0.30 of the European average. However, EthiFinance highlights the significant reduction in the number of people at risk of poverty with an AROPE rate of 16.2% in 2020 (four tenths below the EU) and the reduction of the school dropout rate to 8.9%, also in 2020.

Main financial figures

	2019	2020	2021	2022E	2023E
Real GDP (% change)	2.2%	-8.4%	4.8%	6.7%	2.7%
GDP per inhabitant (current, €)	20,800	19,658	20,840	23,290	-
CPI (annual change, %)	0.3%	-0.1%	0.9%	8.1%	5.1%
Unemployment rate (%labor force)	6.5%	6.9%	6.6%	6.0%	6.5%
People-at-risk (%population)	17.2%	16.2%	18.4%	-	-
Population (thousands)	10,295	10,287	10,345	10,271	-
Dependence ratio	55.1%	55.6%	55.9%	57.4%	-
NPLs	6.2%	4.9%	3.7%	3.0%	-
ROA (financial sector)	0.4%	0.0%	0.4%	0.7%	-
Current Account Balance (%GDP)	0.0%	-1.1%	-1.1%	-1.4%	1.0%
NIIP (%GDP)	-100.8%	-104.8%	-95.90%	-87.7%	-
Fiscal Balance (%GDP)	0.1%	-5.7%	-2.8%	-0.4%	-0.1%
Public Debt (%GDP)	117.7%	135.2%	125.4%	116.0%	112.4%

*1st semester

Press contact:

Thinking Heads

Beatriz Triper - btp@thinkingheads.com –

Office: +34 91 310 7740; Mobile: +34 622 25 95 21 // +34 607 758 253