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# Fitch Revises Portugal's Outlook to Positive; Affirms at 'BBB'

Fitch Ratings - Frankfurt am Main - 06 May 2022: Fitch Ratings has revised the Outlook on Portugal's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Positive from Stable and affirmed the IDR at 'BBB'.

A full list of rating actions is at the end of this rating action commentary.

## Key Rating Drivers

The revision of the Outlook on Portugal's IDRs reflects the following key rating drivers and their relative weights:

**High**

**Fiscal Outperformance:** Fiscal fallout from the pandemic has been less severe than in most European peers, and while the debt ratio is high, it is on a firm downward path. A stronger-than-expected economic recovery, and a degree of spending restraint in the government's pandemic response, have led to better fiscal outturns relative to the eurozone average. Portugal's fiscal deficit reached 2.8% of GDP in 2021 (vs 5.8% in 2020), significantly better than the government's target of 4.3% of GDP, and lower than the average deficit in the eurozone. Portugal's fiscal deficit is also below the current median deficit of 'BBB' category peers at 4.4% of GDP. Meanwhile, the decline in Portugal's debt ratio was the third largest in the eurozone. Debt-to-GDP fell 7.8pp in 2021, compared with an average decline of 1.6pp in the eurozone.

**Political Stability Supports Debt Decline:** The Socialist Party's absolute majority in the Parliament, following January's snap elections, creates a more stable backdrop for policymaking and puts Prime Minister Antonio Costa's government in a strong position to implement its fiscal and economic agenda, which targets a sustained reduction in public debt. A proven record of fiscal discipline, under two previous Costa-led governments (both of which were minority governments), achieved sustained primary fiscal surpluses supporting a 14.6pp decline in debt-to-GDP between 2015-2019. The government's latest Stability Programme (2022-2026) targets Portugal's debt falling back below its pre-pandemic ratio (116.6% in 2019) by 2023. This is broadly consistent with Fitch's own projections, which forecast debt falling below its pre-pandemic ratio in 2024 (to 111.6% of GDP).

Portugal's 'BBB' IDRs also reflect the following key rating drivers:

**NGEU Supports Economic Recovery:** Our baseline is for the Portuguese economy to expand 4.3% in 2022 (vs 4.9% in 2021), despite the shock from higher energy prices and hit to eurozone growth

resulting from the Russia-Ukraine conflict. Challenges of higher inflation and bottlenecks in the supply chain have led us to revise down our 2022 forecast by 1.1pp since November 2021. Eurostat's first estimates of 1Q22 GDP could present some upside. We expect some weakening in private consumption and investment activity. Higher import prices will affect the terms of trade, real incomes, and domestic and external demand. The uncertain external environment poses a downside risk to Portugal for 2H22, but medium-term prospects for the economy remain largely positive, with the pipeline from EU Next Generation funds and 2021-2027 Multiannual Financial Framework (MFF). In Fitch's assessment, effective implementation could contribute to increasing Portuguese output levels by 3.0%-3.5% by 2026, although this would be dependent on the government successfully achieving milestones and targets (including structural reform) attached to the Recovery and Resilience Plan (RRP).

**Downside Risks to Growth:** Under a scenario of a shut-down in gas supply from Russia to the EU (which is not Fitch's base case), we would expect Portugal to be relatively less affected than other EU countries by the direct impact of an energy supply shock, given its low reliance on Russian energy. According to Eurostat, Russia accounted for 4.9% of Portugal's imported energy needs in 2020, below the EU average of 24.4%. However, the resulting higher global energy prices under such a scenario would exert a significant drag on Portugal's growth. Direct trade exposure to Russia and Ukraine is relatively limited. Between 2015 to 2019, Russia and Ukraine accounted for just 0.4% of Portugal's total goods exports, and 2.6% of goods imports. Nonetheless, Portugal's small and highly open economy is not immune from indirect effects from the conflict. Disruptions in global supply chains, higher energy prices and increased uncertainty over the economic outlook of key trading partners (e.g. Spain, Germany and France), all pose significant downside risks to our macroeconomic baseline for Portugal.

**High Debt, Fiscal Risks:** The proposed 2022 Budget targets a deficit of 1.9% of GDP, and outlines discretionary measures (on both the revenue and expenditure side) of 1.8% of GDP, including one-off measures addressing higher energy costs. The government anticipates a EUR1.1 billion fiscal impact (0.5% of GDP) from its energy package (which includes reduced electricity tariffs, fuel subsidies, and lower taxes on diesel and gasoline). The budget forecasts HICP averaging 4.0% in 2022 vs Fitch's forecast of 4.5%. Meanwhile, although Portugal's debt ratio is forecast to remain on a declining path, at 127.4% (2021), it remains the third highest in Europe, and significantly above the current median ratio of 'BBB' category peers (55.3%). The stock of state guarantees, estimated at 9.0% of GDP, the majority related to pandemic credit lines, remain a fiscal risk. Meanwhile, TAP (the state-owned airline) and Novo Banco remain contingent liabilities for the sovereign.

**Inflationary Pressures**: The recent political agreement signed on 27 April between the European Commission, Portugal and Spain for a price cap on wholesale electricity prices could contribute to lower electricity costs. The price cap would be temporary, lasting 12 months. If and when implemented, industries and retail consumers will benefit from lower electricity prices, although it is uncertain to what extent. Portugal's relatively high import content of food products and non-energy industrial goods also leaves inflation vulnerable to global supply disruptions and higher commodity prices. Meanwhile, the risk of domestic inflation pressures increasing could come from tightening in the labour market and general recovery in the services sector.

**Banking Sector Resilience:** In March 2022, Fitch revised the outlook on the banking sector's 'bbb-' operating environment score to stable from negative, reflecting Portugal's economic recovery, and the absence of significant loan impairment charges (LICs) since most moratoriums expired in September 2021. Despite the pandemic shock, the sector's capital metrics improved in 2021 (total capital ratio at 17.9% at end-2021 up from 16.6% end-2019 according to European Banking Authority data. Non-performing loans also declined (reaching 3.5% at end 2021 from 5.7% end 2019). Portuguese banks have very limited exposure to Russian counterparts, around USD170 million (Bank for International Settlements). Direct risks from the sanctions on Russia are therefore low. However, second-order effects from risks of lower eurozone and Portugal economic growth, rising inflation and eroding economic sentiment could weigh on the banks' profitability prospects over 2022-2023. These negative effects could be mitigated by a higher interest rate environment, which is expected to benefit banks' profitability.

**Strong Structural Features:** Portugal's ratings are supported by its institutional strengths, stronger governance indicators and higher level of income per capita than 'BBB' rated peers, anchored by eurozone and EU membership.

**ESG - Governance:** Portugal has an ESG Relevance Score (RS) of '5+' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Portugal has a high WBGI ranking at 82.4 percentile, reflecting its long track record of stable and peaceful political transitions, well established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption.

## RATING SENSITIVITIES

### Factors that could, individually or collectively, lead to negative rating action/ downgrade:

- Macroeconomics: A severe economic downturn or external shock that would lead to a negative revision of our medium-term GDP baseline.

- Public Finances: A deterioration in the projected medium-term outlook for public finances, for example due to pronounced fiscal easing, or a crystallisation of contingent liabilities on the sovereign's balance sheet.

- Structural: Renewed stress in the financial sector that requires significant additional public sector support and/or affects financial stability and the growth outlook.

### Factors that could, individually or collectively, lead to positive rating action/upgrade:

-Public Finances: Evidence that general government debt will remain on a firm downward path, for example due to continuation of sound fiscal policies and/or a stronger economic recovery.

- Macroeconomics: Evidence of improved medium-term growth prospects, for example supported by

implementation of growth-enhancing structural reforms and/or effective use of EU Funds.

## Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Portugal a score equivalent to a rating of 'A-' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- Public Finances: -1 notch, to reflect the high gross general government debt level and the corresponding non-linear risks. The SRM is estimated on the basis of a linear approach to government debt/GDP and does not fully capture the additional risks associated with high debt levels.

- External Finances: -1 notch to reflect the high net external debt and negative net international investment position, which is not captured in the SRM.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

## Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG Considerations

Portugal has an ESG Relevance Score of '5[+]' for Political Stability and Rights as WBGI have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight. As Portugal has a percentile rank above 50 for the governance indicator, this has a positive impact on the credit profile.

Portugal has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and

Control of Corruption as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Portugal has a percentile rank above 50 for the respective governance indicators, this has a positive impact on the credit profile.

Portugal has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as strong social stability and voice and accountability are reflected in the WBGI that have the highest weight in the SRM. They are relevant to the rating and a rating driver. As Portugal has a percentile rank above 50 for the respective governance indicators, this has a positive impact on the credit profile.

Portugal has an ESG Relevance Score of '4[+]' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for the Portugal, as for all sovereigns. As Portugal has a record of 20+ years without a restructuring of public debt, which is captured in our SRM variable, this has a positive impact on the credit profile.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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## Rating Actions

| ENTITY/DEBT | RATING | | | RECOVERY | PRIOR |
|---|---|---|---|---|---|
| Portugal | LT IDR | BBB ⊕ | Affirmed | | BBB ⊙ |
| | ST IDR | F2 | Affirmed | | F2 |
| | LC LT IDR | BBB ⊕ | Affirmed | | BBB ⊙ |
| | LC ST IDR | F2 | Affirmed | | F2 |
| | Country Ceiling | AA | Affirmed | | AA |
| • senior unsecured | LT | BBB | Affirmed | | BBB |

| RATINGS KEY | OUTLOOK | WATCH |
|---|---|---|
| **POSITIVE** | ⊕ | ⬘ |
| **NEGATIVE** | ⊖ | ⬙ |
| **EVOLVING** | ◎ | ◆ |
| **STABLE** | ⊙ | |

## Applicable Criteria

Country Ceilings Criteria (pub.01 Jul 2020)

Sovereign Rating Criteria (pub.11 Apr 2022) (including rating assumption sensitivity)

## Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.13.1 (1)

## Additional Disclosures

Solicitation Status

## Endorsement Status

| Portugal | EU Issued, UK Endorsed |
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