14 July 2020

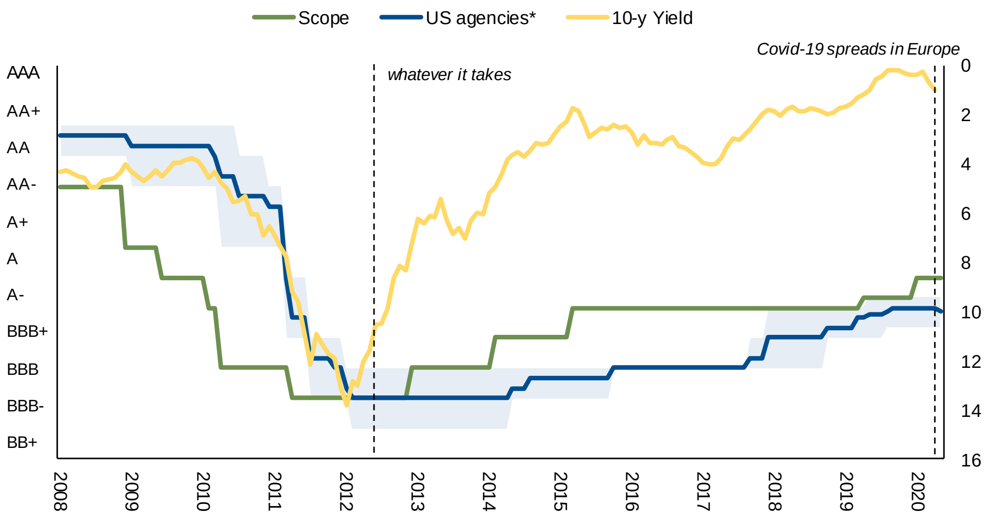
Portugal: Covid-19 shock to weigh on economic and public finances outlook

Portugal (BBB+/Stable), despite having far fewer Covid-19 cases than neighbouring Spain (A-/Stable), will still be as severely affected by the crisis. Portugal's self-imposed lockdown, together with its dependence on the hard-hit tourism sector, will weigh on its 2020 economic performance and labour market dynamics. Public debt will also rise significantly due to extraordinary fiscal stimulus and cyclical deterioration, although ECB support will keep financing costs low. Medium-term debt sustainability dynamics will depend on Portugal's ability to regain its pre-crisis growth potential.

We expect a deep recession for Portugal in 2020, with real GDP shrinking by 10% and a recovery to pre-crisis levels only by 2024. Like in other southern European countries, the Covid-19 crisis will weigh on Portugal's economic performance due to its high share of small and micro businesses and dependence on tourism.

In addition, temporary jobs and informal sectors still take up a high share of Portugal's labour market despite structural improvements in the five years preceding the crisis. With the pandemic putting a halt to economic activity, these labour market vulnerabilities will drive up unemployment, potentially above 10% in 2020.

Figure 1: Portugal's rating history versus its 10-year government bond yield



Source: Bloomberg, Scope Ratings GmbH

Key messages:

- We forecast fiscal deficits of 8.5% in 2020 and 5% in 2021, driven by economic contraction and fiscal support measures. Under our baseline scenario, the debt-to-GDP ratio increases to around 140% in 2020 before gradually decreasing to 133% by 2024. However, in the event of more adverse conditions that dampen the recovery, debt could jump even higher to around 148% of GDP.
- Portugal's favourable debt profile and investor base, with the Eurosystem extensively buying Portuguese securities through the PEPP as well as the substantial share of official loans, have lowered market volatility and financing costs, especially compared to levels during the 2011-12 crisis **(Fig. 1)**.
- Restoring the downward trajectory of its debt-to-GDP ratio – as was the case in the five years prior to the Covid-19 shock – will depend on the country returning to its pre-crisis growth levels. Given Portugal's limited fiscal capacity to respond to the crisis, the speed of its economic recovery may also depend on the fiscal response at the European level.

Analysts

Alvise Lennkh, CFA
+49 69 6677389-85
a.lennkh@scoperatings.com

Giulia Branz
+49 69 6677389-43
g.branz@scoperatings.com

Alessandro Frazzi
+49696677389 79
a.frazzi@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

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Scope Ratings GmbH
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Table1: Growth projections

	Portugal		Euro Area	
	2020	**2021**	**2020**	**2021**
Scope*	-10.0	+5.0	-8.7**	+6.0**
EC	-9.8	+6.0	-8.7	+6.1
IMF	-10.2	+8.1	-7.5	+4.7
ECB	-	-	-8.7	+5.2
PFC	-7.5	+3.0	-	-
BoP	-9.5	+5.2	-	-

* Scope baseline scenario
** Forecasts are from July 2020

Covid-19 shock on the Portuguese economy and labour market

The Covid-19 pandemic has interrupted Portugal's improving trends in economic growth and public finances. After growing 2.5% on average over the last four years, Portugal's economy faces a deep recession in 2020, driven by i) the simultaneous supply and demand shock from pandemic lockdown measures; ii) the restrictions to international travel; and iii) the disruption in international supply chains. Portugal's economic structure is strongly exposed to these channels.

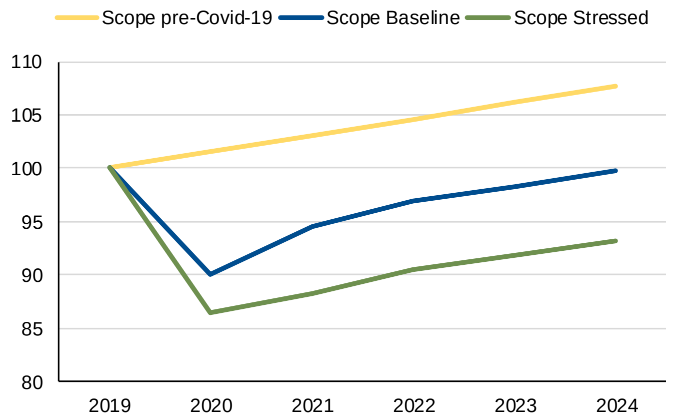
The pandemic has been less severe for Portugal than its southern peers Italy (BBB+/Negative) and Spain, with 43,000 confirmed cases and close to 1,600 deaths. Still, the government's lockdown measures particularly affected the services sector, while other industries such as construction were permitted to continue activity. The first quarter of 2020 saw an unprecedented economic contraction by 3.8% QoQ, compared to the 5.2% decline in Italy and Spain.

Overall, under our baseline scenario, we expect a 10% contraction of real GDP in 2020 before a 5% rebound in 2021. Under a more stressed scenario, involving a second wave of contagion and containment measures in the autumn, we expect a 13.5% contraction in 2020 and a much slower recovery afterwards (details in Annex I). Neither scenario will entail a recovery to 2019 real GDP levels before 2024 (**Fig. 2**).

Portuguese economic structure vulnerable to the crisis given the importance of tourism-related services…

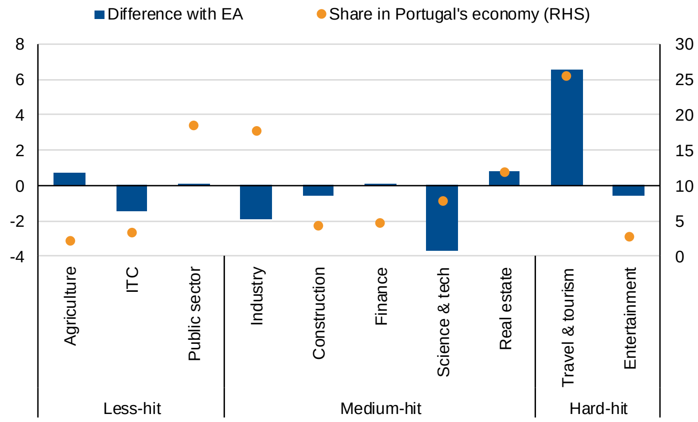
This is because the Covid-19 shock has hit Portugal's services industry the hardest, which accounts for about 66% of GDP. The impact was especially pronounced in tourism and travel-related services, which contribute 25% of GDP, 50% of services exports and 490,000 jobs. As Portugal is the third most tourism-dependent nation in the EU after Croatia and Malta1, travel restrictions have had a major economic impact, especially because 68% of tourism expenditure comes from international visitors. The pace of Portugal's economic recovery is strongly linked to lockdown measures being lifted and the consumption behaviour of international travellers.

Figure 2: Scope real GDP forecasts, % 2019 real GDP



Source: Scope Ratings GmbH

Figure 3: Portuguese economy, by industry, real GVA, 2019



Source: Eurostat, Scope Ratings, GmbH

…and the large presence of small and micro firms

The gravity of the Covid-19 shock on the Portuguese economy also reflects the large share of small and micro businesses, which are more vulnerable to the impacts of the pandemic. Assuming a 40-day shock on economic activity and the provision of State fiscal support, the Bank of Portugal would expect liquidity shortfalls to affect around half of Portuguese firms, mostly micro enterprises operating in accommodation and food services. It is

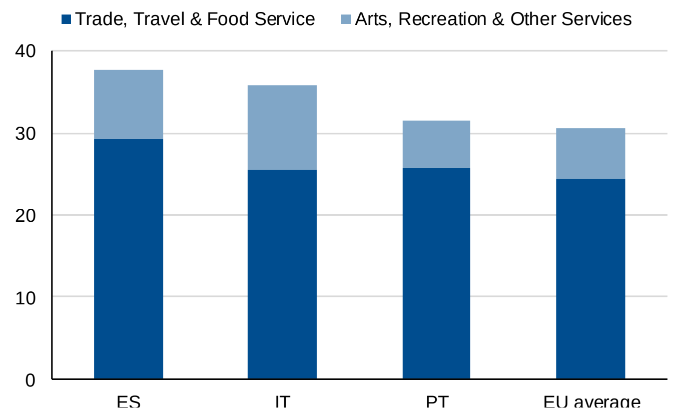
[1] Based on the tourism ratio, which measures the proportion of total domestic supply accounted for by internal tourism consumption.

encouraging that employment is recovering gradually after plummeting in April, suggesting that the lifting of the lockdown measures is starting to yield positive results.

Portugal's dependence on tourism as well as small enterprises with few liquidity buffers explains the large drop in domestic consumption, which is expected to fall much more than the euro area average as consumers increase precautionary savings. Credit card spending and vehicle registration dropped sharply in March and Portugal's Consumer Confidence Indicator declined to -36 in April 2019, lower than the euro area average of -23.

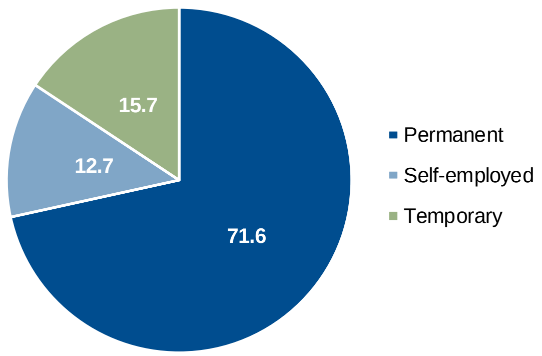
Finally, although industrial activity appears less affected in Portugal than in the euro area2, investment in equipment will be strongly hit by supply chain disruptions as Portugal's core manufacturing sectors (automotive, chemicals, metallurgical and textiles) are heavily linked to international value chains.

Figure 4: Employment in hard-hit sectors, % of the total



Source: National Statistical Institutes, Scope Ratings, GmbH

Figure 5: Employment, by contract type, Q1 2020



Source: AMECO, Scope Ratings GmbH

The pandemic will have a strong effect on the labour market as household incomes deteriorate and unemployment rises. The Bank of Portugal estimates that although 50% of households' finances were not affected by the crisis on average, their total monthly income will decrease by 5.3% and labour income by 8.2%.

High shares of temporary contracts and workers in affected sectors increase vulnerability

Even though Portugal has a smaller share of workers in hard-hit sectors than Spain or Italy (**Fig. 4**), its share of temporary contracts remains the second highest in the euro area after Spain, at 16% as of Q1 2020, even with structural improvements adding more permanent contracts over the last five years (**Fig. 5**). These workers, and those in informal markets, are the most vulnerable to the crisis.

After the unemployment rate reached a 10-year low of 6.5% in 2019, we expect a sharp increase to at least 10% this year. The government has responded by providing financial support to firms suffering a shock on turnover of more than 40%, including via social security exemptions and reductions in remuneration paid by the employer. Although most job losses are likely to be temporary, we still expect a negative permanent effect in the tourism industry after this year, even with government efforts to mitigate the damage.

Fiscal position and policy response

Track record of budgetary adjustments supported building-up of fiscal buffers

Portugal's public finances have improved significantly in the past decade, from a headline deficit of 11.4% of GDP in 2010 to a first-time-ever surplus of 0.2% at the end of last year.

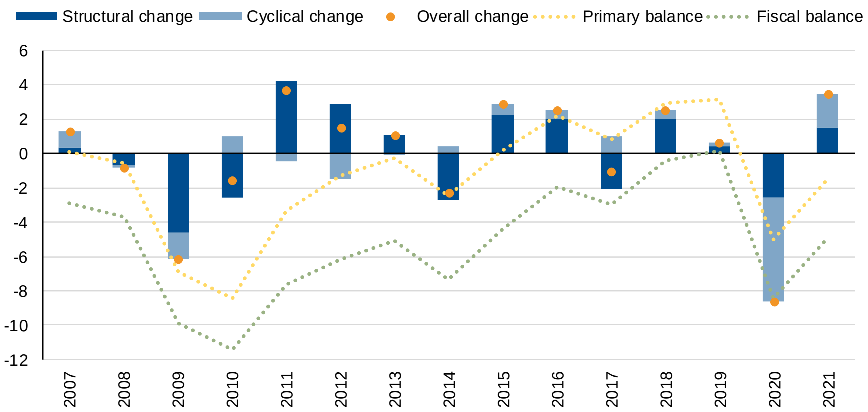
[2] The Industrial Production Index declined in March by 7.2pp in Portugal versus 12.8pp for the euro area, while the Industry Confidence Indicator was down in April by 9pp versus 11.2pp respectively.

A track record of fiscal discipline and structural adjustments facilitated by a favourable economic cycle were the main drivers of the fiscal consolidation process (**Fig. 6**).

Adjustments have come mainly from expenditures, which, as a percentage of GDP, decreased by 9pp between 2010 and 2019 (**Fig. 7**). Continued fiscal consolidation has led to primary surpluses since 2015, which have gradually risen to above 3% of GDP, providing an important fiscal buffer entering into the Covid-19 crisis.

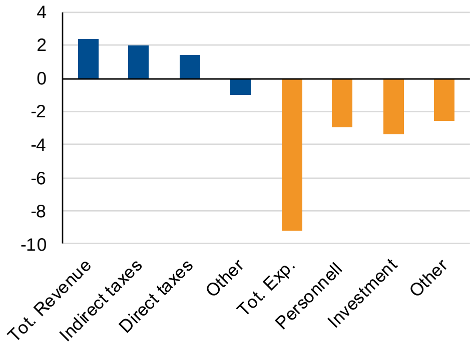
Still, we expect a significant deterioration in the government budget following the Covid-19 shock, driven by the large cyclical deterioration as well as fiscal spending measures by Portuguese authorities. These measures aim to reinforce the health system's capacity, protect jobs, provide social support, and safeguard businesses' liquidity.

Figure 6: Fiscal and primary balances, % of GDP



Source: AMECO, Scope Ratings GmbH

Figure 7: Budgetary adjustments, 2010 vs 2019, % of GDP



Source: AMECO, Scope Ratings GmbH

Significant deterioration in government budget despite relatively small fiscal response

The direct budgetary cost of these measures equates to around 1.7% of GDP, while an additional 7% of GDP relates to public guarantees on loans granted to companies. This is modest compared with the levels of European peers, including Italy and Spain. Overall, we expect a fiscal deficit of 8.5% of GDP in 2020, followed by a gradual decline to around 5% in 2021 driven by the expected economic rebound.

Adverse, one-off impact on public debt level…

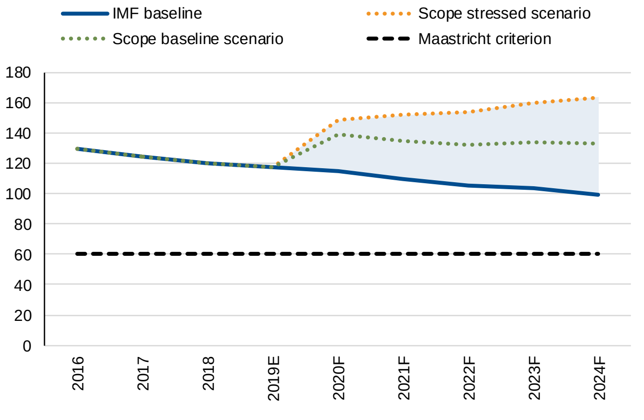
Debt stock on a significant downward trajectory before Covid-19 shock

Portugal's government finances deteriorated significantly after the 2008-09 and 2011-12 financial crises, with the debt-to-GDP ratio rising from 75% in 2008 to its peak of 133% in 2014. The ratio has since fallen to below 118% at end-2019. The 15pp reduction is much greater than that achieved by Spain (-5pp) or Italy (-0.6pp) in the same period. This reflects Portugal's ability to sustain robust growth rates (2.3% on average in 2015-19) and primary surpluses (above 3% in 2019), whereas peers only achieved either robust growth (Spain) or primary surpluses (Italy).

We project a debt-to-GDP ratio of 140% in 2020 followed by a gradual decrease to 133% by 2024

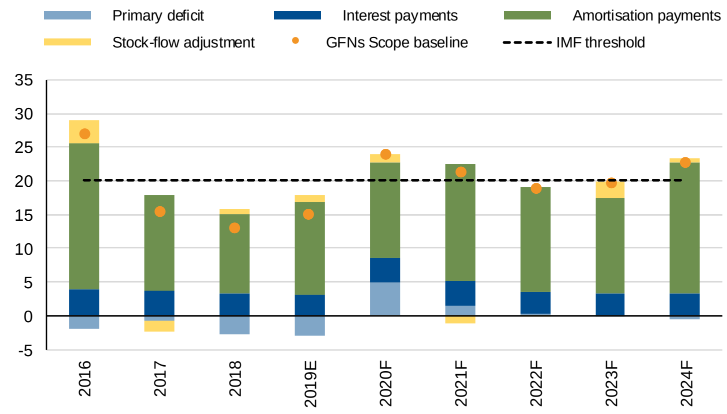
The Covid-19 shock will eventually cause public debt to rise significantly, by about 20pp in 2020. Our debt sustainability analysis (**Fig. 8**) reveals that, in our baseline, Portugal's debt-to-GDP ratio will revert to a decreasing trajectory, although the speed of fiscal consolidation will be inevitably lower than pre-shock scenarios. We project debt-to-GDP to jump to around 140% in 2020 and then gradually decrease to 133% by 2024. In our stressed scenario, entailing more adverse growth and fiscal projections, the debt-to-GDP ratio could jump to 148% of GDP and reach 160% in the medium term (Annex II).

Figure 8: DSA baseline and stressed scenarios, % GDP



Source: AMECO, Scope Ratings GmbH

Figure 9: Gross financing needs, % of GDP



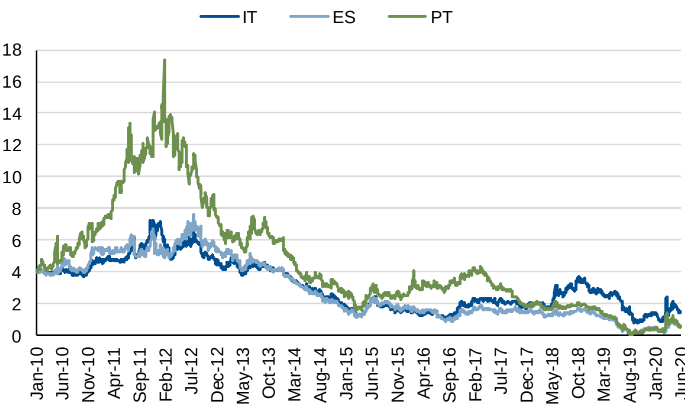
Source: IMF, Scope Ratings GmbH

…mitigated by resilient debt structure and favourable funding costs

Short-term debt sustainability supported by improved debt profile

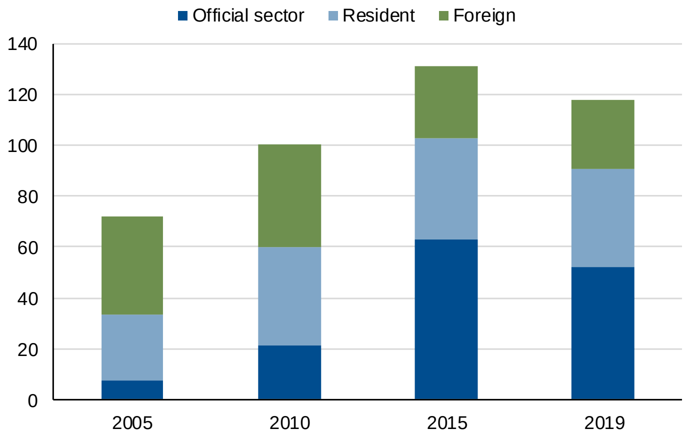
Portugal's short-term debt sustainability has improved thanks to a resilient debt profile, with an average maturity of more than seven years and low annual interest costs of slightly above 1% in 2019, which limit refinancing risks. In our baseline scenario, we expect government gross financing needs to remain at around 20% of GDP, the IMF threshold that qualifies a country as 'high scrutiny' (**Fig. 9**) and well below the peak of around 40% in 2010-11.

Figure 10: Yields on the 10-year government bond, %



Source: Bloomberg

Figure 11: Debt holders, % of GDP



Source: IMF, Scope Ratings GmbH

Solid market access: a key difference from the sovereign debt crisis

In addition, Portugal's financing costs remain very favourable (**Fig. 10**), with a 10-year government bond yield of 0.4% at the time of writing, a major improvement from the peak of 17% during the 2011 sovereign debt crisis, which resulted in Portugal losing its market access. Thanks to low rates, interest payments as a share of revenues are expected to remain at around 8%, thus below 2017 levels despite the increase in debt stock. Still, Portugal's rate remains above Italy's (7.7%) and Spain's (6.1%).

ECB interventions and strengthened EU architecture limit liquidity risks

The ECB's active role and the stronger euro area architecture are two key elements that differentiate the current crisis from the global financial crisis, limiting liquidity risks for the government and reducing volatility in the capital markets. The ECB's pandemic response package will not only keep financing costs low but also indirectly absorb a significant share of Portuguese government securities. We estimate the ECB will buy up to EUR 25bn in Portuguese debt by end-2020, almost 10% of the country's total debt stock. This is in addition to the official sector loans, including the 2010-13 IMF/EU financial assistance programme. At the end of 2019, 44% of Portuguese public debt was held by the official sector (**Fig. 11**), significantly reducing its risk profile and shielding the government from market volatility. Adding the expected ECB purchases is likely to result in the official sector, including the ECB holding almost 50% of Portugal's public debt stock.

EU fiscal package may help support growth potential recovery over the medium term

As a result, debt sustainability risks in the short term are limited for Portugal, given the ECB's decisions but also, potentially, the safety net provided by the ESM's pandemic support line. In the medium term, however, debt sustainability will depend crucially on the country's growth after the Covid-19 shock, as this will facilitate a return to a downward trajectory of the debt-to-GDP ratio.

The relatively small size of fiscal policy measures at the national level may thus be critically complemented by the EUR 750bn 'Next Generation EU' recovery fund announced by the EU Commission. While still under negotiation, Portugal may have access to EUR 15.5bn (7% of GDP) in grants and EUR 10.8bn (5% of GDP) in loans, for a total of EUR 26bn over 2021-24. This amount is greater than Portugal's total investment spending between 2013 and 2019. In addition, as the funds shall be disbursed in tranches depending on reform progress, the plan may incentivise the use of structural reforms that raise growth potential.

Annex I: Forecasting assumptions regarding 2020 economic growth

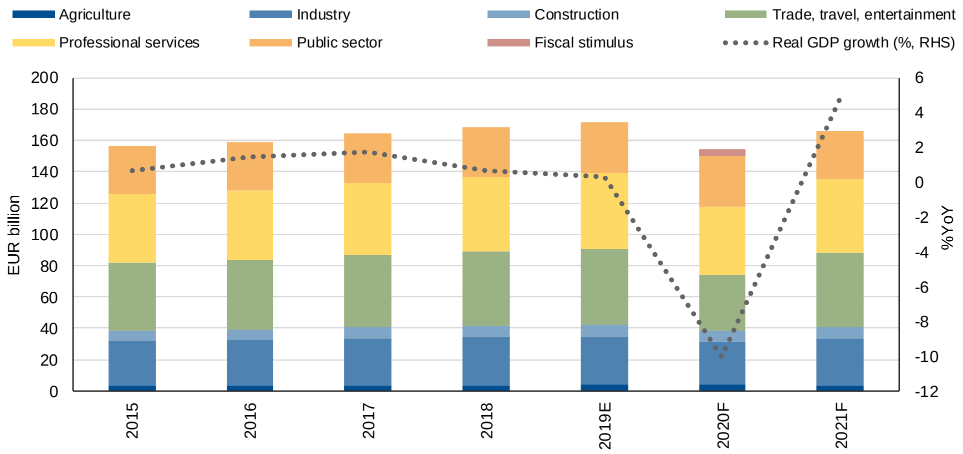
For 2020, we use a model based on a gross value-added calculation of GDP and run two scenarios (baseline and stressed), defined by the timing and shape of recovery in activities of various industry sectors. We classify industry sectors as operating during the crisis at either i) near-full capacity; ii) medium capacity; or iii) low capacity. This assessment is based on the severity of the synchronised demand and supply shock in 2020.

Impact of demand/supply shock		
Low	**Medium**	**High**
• Agriculture, forestry and fishing • Information and communication • Public administration, education and social work	• Industry • Construction • Real estate • Financial and insurance • Professional services, science and technology	• Trade, travel, accommodation and food • Arts, entertainment and recreation

We thereafter enter assumptions on the monthly loss in productive output compared with pre-crisis levels for each of the three high-level impact classifications and for the industries that are assigned and fall under each of the three classifications. The assumptions also account for the growth-positive effects of fiscal countermeasures announced by the government to date.

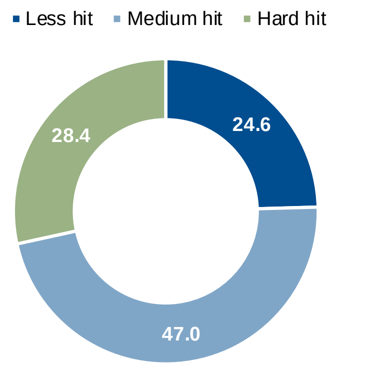
Our baseline scenario entails a gradual recovery into 2021 after containment measures were relaxed. Throughout 2020, we assume declines in productive capacities of around 0-5% for low-hit sectors, 10% for medium-hit sectors, and 30% for hard-hit sectors in the case of Portugal. We then adjust for the impact of announced fiscal stimulus measures, differentiating between various types of government spending and liquidity assistance.

Figure 12: Portugal's economy by production (real GVA)
EUR billion (LHS) and %YoY (RHS)



Source: Eurostat, Scope Ratings

Figure 13: Industry categorization
% of Portuguese economy



Source: Eurostat, Scope Ratings

We also estimate a downside economic scenario, which considers a possible second wave of contagion in the autumn and the consequent re-introduction of containment measures in the fourth quarter, which also causes a much slower recovery in 2021. The results for real GDP growth in 2020-21 are presented as follows:

Scenarios	2020	2021
Baseline	-10.0	5.0
Stressed	-13.5	2.0

Annex II: Debt sustainability analysis assumptions

Our **baseline** debt projections derive from the following assumptions:

Factor	2015-19	2020	2021	2022	2023	2024
Real GDP, %YoY	2.3	-10.0	5.0	2.5	1.5	1.5
GDP deflator, %YoY	1.6	1.0	1.5	1.6	1.7	1.7
Primary balance, % GDP	1.7	-5.0	-1.5	-0.2	0.2	0.6
Interest payments, % GDP	3.7	3.5	3.6	3.4	3.4	3.3
General government debt, % GDP	*117.7*	*140.0*	*135.0*	*133.0*	*134.0*	*133.0*

- -10% growth in 2020 followed by +5% in 2021, then convergence to Portugal's growth potential of 1.5% as estimated by Scope;
- Budget deficit of just over 8.5% of GDP in 2020, followed by 5.0% in 2021 and gradual deficit reductions thereafter;
- Weaker annual increases in the GDP deflator, especially in 2020, to reflect weak economic conditions;
- 50bps higher average real effective interest rate vis-à-vis IMF pre-shock baseline; and
- Crystallisation onto the sovereign balance sheet of contingent liabilities from government guarantees: 0.2% of GDP per year vis-à-vis IMF pre-shock baseline.

Our **stressed** debt projections derive from the following assumptions:

Factor	2015-19	2020	2021	2022	2023	2024
Real GDP, %YoY	2.3	-13.5	2.0	2.5	1.5	1.5
GDP deflator, %YoY	1.6	0.5	1.3	1.4	1.5	1.5
Primary balance, % GDP	1.7	-8.0	-5.0	-4.0	-3.5	-3.0
Interest payments, % GDP	3.7	3.6	4.0	4.0	4.0	4.0
General government debt, % GDP	*117.7*	*148.5*	*152.0*	*154.0*	*160.0*	*163.0*

- -13.5% growth in 2020 followed by +8.0% in 2021, then convergence to the growth potential of 1.5%;
- Budget deficit of 12% of GDP in 2020, followed by 6% in 2021, including fiscal support in addition to those announced, and gradual deficit reductions thereafter;
- Weaker annual increases in the GDP deflator, especially in 2020, to reflect weak economic conditions;
- 75bps higher average real effective interest rate vis-à-vis IMF pre-shock baseline; and
- Crystallisation onto the sovereign balance sheet of contingent liabilities from government guarantees: 0.6% of GDP per year vis-à-vis IMF pre-shock baseline.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75009 Paris

Phone +33 1 82 88 55 57

London
3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com