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## **DBRS Confirms Republic of Portugal at BBB (low), Stable Trend**

### **Industry: Public Finance--Sovereigns**

DBRS Ratings Limited has confirmed the Republic of Portugal's long-term foreign and local currency issuer ratings at BBB (low) and short-term foreign and local currency issuer ratings at R-2 (middle). The trend on all ratings remains Stable.

The rating confirmation reflects DBRS's assessment of Portugal's improved credit profile in recent years, following the substantial progress in the reduction of the fiscal and external imbalances. Improvements in the public debt repayment profile as well as the commitment at the Euro area level to ensure financial stability in the region provide additional support to the ratings. However, Portugal also faces significant challenges, including elevated levels of public sector debt, ongoing fiscal pressures, low potential growth, and high corporate sector indebtedness. Moreover, political uncertainty has increased following inconclusive election results in October.

Portugal is benefiting from an ongoing economic recovery, the continued narrowing of the fiscal deficit, and the incipient decline in the government debt ratio. Recent election results suggest a more gradual fiscal consolidation path. However, DBRS does not currently expect a return to large fiscal imbalances and believes that risks remain broadly balanced. The ratings could come under downward pressure if there is a weakening in the political commitment to sustainable economic policies, if weaker-than-expected growth leads to a deterioration in public debt dynamics, if a reversal of structural reforms were to occur, or if political uncertainty persists. Conversely, the ratings could be upgraded if the improvement in public finances is sustained and the economic recovery proves durable, thereby improving the outlook for public debt sustainability.

Following the October general elections, which failed to produce a majority government, the outlook for macroeconomic policy has clouded. The presentation of 2016 budget has been delayed, which increases the uncertainty over the pace of further fiscal adjustment. Nevertheless, DBRS does not currently expect a turnaround of the substantial progress that Portugal has made in unwinding macroeconomic imbalances. Public finances have undergone a sizable adjustment, with the fiscal deficit narrowing to a projected 3.0% of GDP in 2015 from 11.2% in 2010. Importantly, the improving deficit position has placed public debt dynamics on a downward trajectory this year. On the external side, improved export performance, together with import compression, has led to a large adjustment in the external accounts. The current account shifted from a deficit of 12.1% of GDP in

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2008 to a small surplus of 0.6% in 2014. Overall, the fiscal and external adjustments have placed the economy in a better position to support the recovery. Real GDP growth is forecast to average 1.7% in 2015-2016.

Moreover, active debt management operations combined with favourable market conditions have lowered the government's funding costs and improved its debt maturity profile. Since returning to debt markets in 2013, the government has also carried out several debt management operations and it started to repay part of its IMF loans this year, thus mitigating risks arising from its large financing needs.

As a member of the Economic and Monetary Union (EMU), Portugal benefits from the strong credibility of Euro area institutions, in particular that of European Central Bank (ECB). In this respect, Portugal has benefited from the ECB's programmes, which have helped ease tensions in the sovereign bond markets. The quantitative easing programme launched in March 2015 should help keep government borrowing costs in the markets low. DBRS believes that additional EU financial support would likely be available if necessary.

However, these positive credit factors are counterbalanced by important underlying credit weaknesses. First, gross general government debt – at 130.2% of GDP in 2014 – is very high. As a result, the government's fiscal flexibility is limited and the country is vulnerable to adverse shocks.

The reduction of the deficit is now largely relying on the cyclical recovery, and thus additional structural fiscal adjustment might be needed to firmly place debt dynamics on a downward trajectory and support the sustainability of public finances. Some of the austerity measures implemented under the EU/IMF programme are also being reversed, and offsetting measures are not yet clear. At the same time, medium-term growth assumptions could prove optimistic. DBRS does not currently expect major deviations in the fiscal position, but given that the fiscal adjustment is now expected to be more gradual than anticipated, we would be concerned if durable economic growth fails to materialize. We would also be concerned if any fiscal slippage turns persistent and if privatizations are reversed.

Moreover, Portugal's potential growth remains low. Although structural reforms have been implemented over the past four years, the economy continues to show low levels of investment, insufficient competition in the non-tradable sector and rigidities in the labour market. With weak investment and still-high long-term unemployment, the contributions from capital accumulation and labour supply to medium-term economic growth appear limited. Therefore, we would be concerned if reforms are reversed. Finally, adding to the challenges facing Portugal is the high level of



indebtedness of non-financial corporates. Corporate sector debt, at 108% of GDP at end-2014, has weighed on investment and affected the performance of the banking sector.

Notes:

All figures are in euro (EUR) unless otherwise noted.

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Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Portugal, Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Nov 13, 2015
Portugal, Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Nov 13, 2015
Portugal, Republic of	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (low)	Stb	Nov 13, 2015
Portugal, Republic of	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (low)	Stb	Nov 13, 2015

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