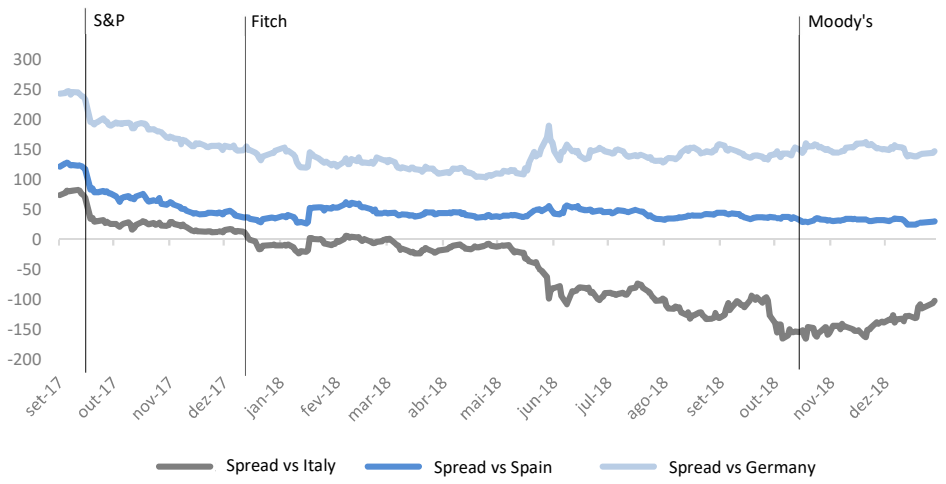
Box 2.2 | Return to investment grade

The year 2018 ended with Moody's placing the rating back at investment grade level, marking the return of Portugal to this level by the three biggest rating agencies, something that had not happened since 2011. This is a clear sign that improvements in macroeconomic performance, fiscal consolidation and public debt dynamics are recognised internationally.

Moody's upgraded the Portuguese Republic's rating to Baa3, the first level of investment grade, on 12 October. The robustness of the Portuguese public debt market was confirmed by the significant demand in the auction in November, as well as in the exchange in early December, which, together with the sound budget execution, made it possible to prepay the outstanding credit to the IMF. As Moody's decision was long awaited by the market, its impact was not as significant as that felt with the upgrade of the two other agencies, in particular the first one, undertaken by S&P.

Graph 17 – Spread of Portugal vs Spain, Italy and Germany in 10-year *OT*



Source: Bloomberg

Throughout 2018, spreads against Spain and Germany remained stable. Notwithstanding a widening of the spread versus Germany shortly after the Italian elections (in May and June), it narrowed during the summer, with the value remaining practically unchanged until the end of the year. The absence of a contagion effect (from the events in Italy to the Iberian markets) confirmed the robustness of Portuguese public debt, highlighting the contrast with the evolution of financing conditions after the global financial crisis.

The current rating is reflected in the base of investors seeking Portuguese debt, which is now broader in terms of geography and entities. The improved rating not only increased the number of Portuguese debt investors but also their quality. The vast majority of investors who were limited in their purchases of Portuguese public debt before the rating upgrade were insurers, pension funds and asset managers, institutions that are now returning to the Portuguese market. More speculative investors, such as hedge funds, are starting to give way

to more conservative investors, which is the normal course, to be expected following the country's return to investment grade status.

2.3. State Direct Debt and Costs

On 31 December 2018, Portuguese State direct debt[12] evaluated at the end-of-period exchange rate stood at EUR 245.6 billion (see Table 20 in Annex 5), which represents an increase of EUR 7.3 billion compared to 2017 (3.1%). The annual change is mainly due to the increase in the *OT* balance (contribution of 3.5pp), *CEDIC* (1.5pp) and *CT* (0.6pp), partially offset by the decrease in EFAP loans (-2.3 pp) and the *BT* balance (-0.8pp).

In 2018, and as observed since 2015, the Republic's main source of net financing was the issuance of medium- and long-term debt. Gross issuance of *OT,* net of premiums and discounts, was EUR 18.7 billion, translating into a positive net issuance of EUR 9.1 billion and resulting in an increase in the relative weight of *OT* in the debt stock (nominal value), from 49.0% in 2017 to 50.9% at the end of 2018. Adding the balance of *OTRV* and MTN in euros, the overall weight of medium- and long-term tradable debt issued in euros was 55.1% (compared to 52.9% in 2017).

The weight of retail instruments (*CA* and *CT*) increased slightly from 11.3% to 11.5%, mainly reflecting the positive performance of *CTPC*, whose subscriptions remained high in 2018.

Short-term debt (in euros) increased by around EUR 1.7 billion in 2018, mainly due to the evolution of *CEDIC* (net issuance of EUR 3.6 billion), which more than offset the reduction in the stocks of *BT* (of approximately EUR 1.8 billion) and of accounts payable of cash-collateral related with financial derivatives to hedge interest rate and exchange rate risk (around EUR 0.1 billion). In this regard, the relative weight of short-term debt instruments increased from 8.4% to 8.8% at the end of 2018.

The weight of non-euro denominated debt (excluding EFAP loans) remained relatively stable in 2018 (around 1.6%).

In turn, EFAP loans decreased their relative weight in the debt stock, from 23.9% in 2017 to 21.0% at the end of 2018, due to the early repayment of the IMF loan outstanding. The amount paid in 2018 was SDR[13] 4.6 billion, equivalent to EUR 5.5 billion, of which EUR 0.8 billion was paid in January and EUR 4.7 billion in December.

The favourable exchange rate effect of hedging derivatives (net) decreased slightly to EUR 0.6 billion, compared with EUR 0.7 billion in the previous year. Debt after cross-currency hedges stood at EUR 245.0 billion, an increase of EUR 7.4 billion compared to 2017.

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[12] State direct debt is a concept that differs from debt compiled by Banco de Portugal for the purposes of the Excessive Deficit Procedure (Maastricht debt, presented in Graph 5) in various aspects, among which: (i) sector delimitation differences – the State direct debt includes only the debt issued by the State, while the Maastricht debt includes all rated entities, for statistical purposes, in the institutional sector of the general government; (ii) consolidation effects – the State direct debt reflects only the liabilities of this sub-sector, while the Maastricht debt is consolidated, i.e. it excludes the assets of public administration in liabilities issued by their own government; (iii) capitalisation of savings certificates – the State direct debt includes the accumulated capitalisation of savings certificates, which is excluded from the Maastricht definition.

[13] Basket made up of USD, EUR, GBP, JPY and CNY.