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Economic activity accelerated in 2017. Strong consumption and investment growth supported the cyclical upswing. Despite fiscal over-performance, prudent fiscal policies must continue to push the high level of debt onto a permanent downward trajectory. While the health of the banking system in Portugal improved and demonstrated clear progress, vulnerabilities remain owing to low profitability and high NPL levels.

In Portugal, GDP growth accelerated to 2.7% in 2017 from 1.6% in 2016 and 1.8% in 2015. The year-on-year quarterly growth rate was particularly strong in the first half of the year compared to the second half. Investment and private consumption primarily drove growth. Net exports' contribution to growth has been negative but small, as import growth triggered by buoyant domestic demand slightly outweighed export growth. The boost from private consumption, however, should gradually fade given high household indebtedness, while any material increase in labour costs would constrain the economy's competitiveness. Labour market developments are positive; the unemployment rate fell to 9% in 2017 from 11.2% in 2016.

Due to the classification of the one-off recapitalisation for Caixa Geral de Depósitos as a capital transfer, the budget deficit in 2017 increased to 3.0% from 2.0% in 2016. However, when excluding this temporary impact, the 2017 fiscal result stands at 0.9% of GDP, below the 1.4% of GDP target set in the 2018 budget. Improved revenue performance and contained expenditure growth drove this outperformance. Government debt is expected to fall to 122.5% of GDP in 2018 from 125.7% in 2017 following the strong fiscal performance and growth acceleration. Fiscal over-performance allowed Portugal to repay more IMF loans early and smooth its debt maturity profile – producing savings from lower debt servicing costs. After the early repayments in 2017 and early 2018, the outstanding IMF loan liability is currently at 187.5% of Portugal's quota (€4.60 billion).

In 2017, S&P and Fitch upgraded Portuguese government bonds to investment grade in view of the positive economic prospects. Portugal's economic performance and the ECB's accommodative monetary policy helped steer the government bond market, shifting the yield curve downwards. At year-end, the 10-year benchmark bond was trading at 1.9% and a 152 basis point spread to its German counterpart. Moreover, the most recent Fitch upgrade to investment grade drove its 10-year spread to Italian peers into negative territory for the first time since the onset of the European sovereign crisis.

The fundamentals of the banking sector significantly improved throughout 2017. The average capital level increased to 13.9% of risk-weighted assets (CET1 ratio) in 2017 from 11.4% at the end of 2016, stemming from capital increases at Banco Comercial Português (BCP), Caixa Geral de Depósitos (CGD), and Novo Banco. The sector's profitability recovered in the first nine months of 2017 compared to the previous year while NPLS visibly declined to a still high 13.3%. Novo Banco, the bank emerging from the resolution of Banco Espirito Santo in 2014, has been partially privatised and is now 75%-owned by the US private equity group Lone Star. The resolution fund is still liable for future losses due to a capital contingent mechanism for Novo Banco.

The Early Warning System suggests no immediate repayment risk, but Portugal still faces challenging debt dynamics. Weaker growth, fiscal consolidation fatigue, or an increase in interest rates would slow the public debt ratio's downward trend as foreseen in the short- to medium-term horizon. In this respect, prudent fiscal policies will be important to ensure a continued decline of public debt. To boost long-term growth and reduce the effects of a shock to the economy, it is important to continue efforts on structural reforms to support investment and productivity and to capture export market share. At the same time, rising house prices need to be closely monitored. In the banking sector, the focus should be on the high level of NPLs and on low bank profitability.