Portuguese growth accelerated in the second half of 2016, although annual GDP growth was slightly lower than in 2015. Potential growth remained mild. Import demand resulting from private consumption and equipment investment prevented net exports from turning positive. The Portuguese government has corrected the excessive fiscal deficit. Efforts to entrench prudent fiscal policies to put the high debt stock on a downward trajectory must be strengthened. The Portuguese banking system remains vulnerable due to low profitability and high NPLs, however, the recapitalisation of the two largest banks represented a positive development.

In Portugal, real GDP growth slowed to 1.4% in 2016 from 1.6% in 2015. Economic activity remained slow in the first half of the year, and decelerated overall for the year despite a marked acceleration in the second half. Construction investment declined while private consumption, private investment in non-financial corporations, and exports drove growth. The rise in the minimum wage continued to support consumer spending, but increasing labour costs may put at risk past competitiveness gains. Imports due to buoyant domestic demand counterbalanced external demand for Portuguese goods and services. Helped by a smaller deficit in primary income, the current account surplus increased to 0.8% of GDP.

The government deficit more than halved to 2.0% of GDP in 2016 from 4.4% in 2015. Excluding one-off measures, it fell to 2.3%. The budget deficit was lower than the target set by the European Council and it was the first time that it has fallen below the Stability and Growth Pact's 3% threshold since the Pact was agreed in 1997. Hefty expenditure reductions, notably for public investment, compensated for lower-than-expected revenues.

Government debt increased to 130.4% of GDP in 2016, which is only marginally lower than the peak of 130.6% recorded in 2014. However, the increase stemmed principally from debt issuance for a capital investment in the state-owned bank Caixa Geral de Depósitos (CGD), the largest bank in the country, as agreed with the European Commission. The state's cash position improved, increasing to around €10 billion, or 5.5% of GDP, at the end of 2016.

During most of 2016, Portugal retained good access to capital markets at advantageous terms amid episodes of volatility and a gradual increase in market yields. Portugal's economic performance, the ECB's monetary policy operations, and the international environment all influenced the government bond market. The 10-year bond yield stood at 3.7% at the end of 2016, with the spread vis-a-vis the German Bund increasing by 167 basis points over the year. Portugal diversified its funding sources through retail market issuances and realised interest savings, the latter by completing the planned early repayment of half of its IMF loan by early 2017. It also built up its liquidity buffer – now equal to half of its projected funding needs – which should not be reversed.

The banking sector still remains vulnerable but fundamentals are improving. The average capital level stood at 11.4% of risk weighted assets (CET1 ratio) as of December 2016. Capitalisation has, however, increased since then with foreign investors' €1.33 billion capital increase of Banco Comercial Portugues (BCP) and the €3.9 billion recapitalisation of CGD. Additionally, BPI reduced its risk profile by decreasing its exposure to Angola. Profitability fell significantly in 2016 compared to the previous year while NPLs are still high. Novo Banco, the bank emerging from the resolution of Banco Espirito Santo in 2014, is still in the process of being sold by the Resolution Fund, with the sale expected by August 2017 at the latest.

The Early Warning System suggests that reduction of the large public debt stock remains challenging, in particular if interest rates increase while potential growth remains weak. To boost long-term growth, Portugal should continue to take the measures promoting competitiveness recommended by the European Council. Portugal should also continue to address the high NPL stock on the banks' balance sheets. Debt sustainability furthermore calls for highly prudent fiscal policies over an extended period in line with the requirements under the European fiscal governance framework.