Notes on the Budget Report for 2016

- **On February 5th, the Government submitted to Parliament the Budget Report for 2016, proposing a reduction of the budget deficit to 2.2% of GDP (from 4.3% in 2015), which encompasses a structural adjustment of 0.3pp of GDP**
- **The macro scenario points to a continued recovery in the economic activity, with GDP growing 1.8% in 2016 (after 1.5% in 2015), on the back of strong domestic and external demand and a gradual recovery of investment and labor market conditions**
- **Fiscal consolidation will be achieved through a combination of expenditure reduction and revenue increase, which more than offsets the partial reversion of previous wage cuts and of the surcharge on Personal Income Tax**
- **Public debt is expected to decline around 1pp of GDP (to 127.7%), but the reduction may be larger if/when potentially favorable inflows from the financial sector materialize (e.g. from the sale of Novo Banco or the reimbursement of outstanding CoCos)**
- **In January IGCP launched a new 10-year benchmark with a nominal value of €4 bn and more recently, on the back of Banif's resolution measure, IGCP has also issued a 10-year EMTN amounting to €1.8 bn**
- **In early February IGCP continued pre-paying the IMF loan, having reimbursed €2.0 bn (together with the €8.4 bn reimbursed in 2015, 36% of the total amount outstanding has been already repaid)**
- **Potential additional pre-payments on the IMF loan (about €2.6 bn this year) are dependent on market conditions and on the sale of financial assets; thus, the funding needs to be covered with MLT debt issuance for the remainder of 2016 amount to about €12 bn**

Macro scenario foresees a moderate acceleration of GDP growth

On February 5th, the government submitted to Parliament the 2016 Budget Report. The macroeconomic scenario predicts an acceleration of GDP growth to 1.8%, up from expected 1.5% in 2015.

GDP is projected to grow 1.5% in 2015 and 1.8% in 2016 (in line with the most recent BdP and European Commission projections)…

Domestic demand will keep its contribution to GDP growth at 2.2pp, as the slowdown in private consumption (from an annual growth rate of 2.6% in 2015 to 2.4% in 2016) will be compensated by the acceleration of public consumption (from -0.7% to 0.2%) and investment (4.3% to 4.9%).

Macroeconomic scenario

			2016 Draft Budget		Banco de Portugal			European Commission		
	2013	2014	2015 P	2016 P	2015 P	2016 P	2017 P	2015 P	2016 P	2017 P
Real GDP (yoy %)	**-1,1**	**0,9**	**1,5**	**1,8**	**1,6**	**1,7**	**1,8**	**1,5**	**1,6**	**1,8**
Private consumption	-1,2	2,3	2,6	2,4	2,7	1,8	1,7	2,6	1,9	1,8
Public consumption	-2,0	-0,5	-0,7	0,2	0,1	0,3	0,1	0,3	0,4	0,4
GFCF	-5,1	2,8	4,3	4,9	4,8	4,1	6,1	4,3	3,0	4,7
Exports	7,0	3,9	5,1	4,3	5,3	3,3	5,1	4,9	4,3	5,3
Imports	4,7	7,2	6,9	5,5	7,3	3,6	5,6	6,5	4,9	6,0
Contributions to GDP growth (pp)										
Domestic demand	-2,0	1,8	2,2	2,2	-	-	-	2,4	1,8	2,0
Inventories	0,0	0,3	-	-	-	-	-	-0,3	0,0	0,0
Net exports	0,9	-1,2	-0,7	-0,4	-	-	-	-0,6	-0,2	-0,2
Contributions to GDP growth net of imports (pp)										
Domestic demand	-	*0,3*	-	-	1,1	*0,9*	*0,9*	-	-	-
External demand	-	*0,6*	-	-	0,4	*0,8*	*0,9*	-	-	-
External sector (% GDP)										
Goods and services	1,0	0,4	1,0	1,2	1,6	1,7	1,3	-	-	-
Current account	0,7	0,3	0,6	0,9	-	-	-	0,7	1,1	1,1
Current and Capital account	2,3	1,7	2,0	2,2	2,4	2,5	2,3	-	-	-
Unemployment (% labor force)	**16,2**	**13,9**	**12,3**	**11,3**	**-**	**-**	**-**	**12,6**	**11,7**	**10,8**
Prices (yoy %)										
GDP deflator	2,3	1,0	1,9	2,0	-	-	-	1,7	1,5	1,3
HICP	0,4	-0,2	0,5	1,2	0,6	1,1	1,6	0,5	0,7	1,1

Source: Statistics Portugal, Ministry of Finance, Banco de Portugal and European Commission

The GDP growth acceleration will benefit from a less negative contribution of net exports (-0.7pp in 2015 and -0.4pp in 2016), resulting from a stronger slowdown of imports than exports. This will contribute to an improvement of the external accounts, with the current and capital account reaching 2.2% of GDP.

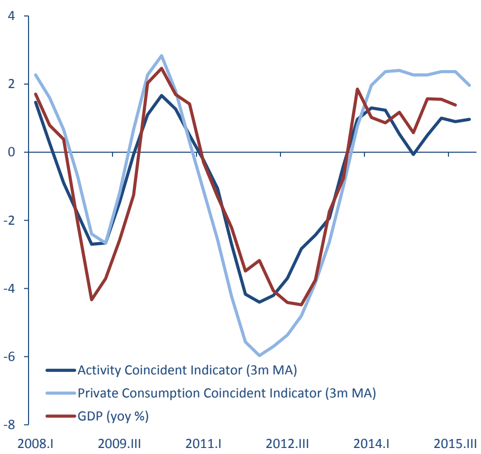
… and inflation is expected to progressively increase to more than 1% in 2016

Unemployment is expected to continue the descending trend to 11.3% in 2016, while inflation is expected to increase, from an average annual growth rate of 0.5% to 1.2% in 2016. As in previous years, the GDP deflator will be higher than HICP inflation, on the back of an improvement of the terms of trade that is likely to be translated into improved profitability of domestic firms.

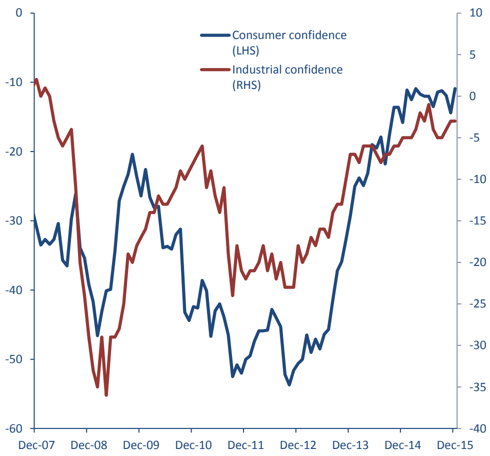
High frequency indicators continue to signal a stable growth environment

High frequency indicators point to a steady recovery. While the coincident indicators have stabilized at relatively high levels in the last months of 2015, consumer and industrial confidence have improved further.

GDP and coincident indicators
(%)



Consumer and industrial confidence
(balance between positive and negative assessment)



Source: Statistics Portugal and Banco de Portugal

According to the more recent data published by Statistics Portugal, nominal exports and imports of goods declined in the last quarter of 2015, with yoy changes of -0.2% and -0.9% respectively, largely reflecting price declines in the energy component. The overall result for 2015 implies an increment of the exported goods by 3.6% and of the imported goods by 1.7% in nominal terms.

Statistics Portugal has also published recently the figures for the unemployment rate in 2015Q4, standing at 12.2% (0.3pp above Q3 and 1.3pp bellow 2014Q4) for an annual average of 12.4% (1.5pp lower than in 2014).

Inflation increased in January, with the HICP increasing 0.7% yoy (from 0.3% in December), which compares with 0.4% for the euro area. Core CPI presented a similar movement, increasing 0.5pp to 1%.

Fiscal consolidation continues with a deficit forecast of 2.2% of GDP

Budget deficit is expected to fall below 3% of GDP in 2016…

In terms of public finances, the Portuguese Government reaffirmed its commitment to comply with the European framework established under the Fiscal Compact. The fiscal consolidation will continue in 2016, with the deficit target set at 2.2% (under the Excessive Deficit Procedure 3% limit) and an estimated structural effort of 0.3pp of GDP.

In 2015 the budget balance is estimated at 4.3% of GDP, including 1.2 pp of Banif resolution effect (final figures to be released by Statistics Portugal towards the end of March).

The overall budget adjusted by more than 6pp of GDP …

Between 2010 and 2015, the GG deficit overall balance has improved 6.9pp (5.8pp excluding one-offs). The structural balance improved 6.6pp of GDP over the same period, reaching a deficit of 2.0% of potential GDP in 2015. In 2016, the estimate points to an improvement of 0.3pp of GDP, explained by an increase of revenue (the expenditure contribution is null).

… and the primary balance by more than 8pp of GDP

Over the same period, the primary balance improved by 8.6pp of GDP (7.5pp excluding one-offs and 8.4pp in structural terms), reaching an estimated surplus of 0.4% of GDP in 2015 (1.5% excluding one-offs).

Structural balance gradually approached the MTO of -0.5% of potential GDP, after an improvement of 6.6pp of GDP in 2010-15

OVERALL BALANCE	2010	2011	2012	2013	2014	2015e	2016p
Overall balance	-11,2	-7,4	-5,7	-4,8	-7,2	-4,3	-2,2
Overall balance excluding one-offs	-9,0	-6,9	-5,5	-5,1	-3,4	-3,2	-2,2
Structural overall balance	-8,6	-5,8	-3,0	-2,6	-1,5	-2,0	-1,8

PRIMARY BALANCE	2010	2011	2012	2013	2014	2015e	2016p
Primary balance	-8,2	-3,1	-0,8	0,0	-2,3	0,4	2,3
Primary balance excluding one-offs	-6,0	-2,6	-0,6	-0,3	1,5	1,5	2,3
Structural primary balance	-5,7	-1,5	1,9	2,3	3,5	2,7	2,8

Source: Statistics Portugal and Ministry of Finance

In 2016, the overall budget balance is expected to improve 2.1pp (1.0pp excluding one-offs), which shall be achieved through an expenditure reduction of 2.0pp of GDP (mainly reflecting the base effect related with the recapitalization of Banif, which implies a reduction of capital expenditure by 1.6pp of GDP), coupled with an increase in revenue of about 0.2 pp of GDP (see detailed breakdown in Annex 1).

Among the main measures aimed to promote the fiscal consolidation effort in 2016 we have the following:

- Limit intermediary consumption expenditure (through nominal freezing) (€0.3bn);
- Sectorial savings and processual administrative simplification (€0.2bn);
- Social action and improvement of control mechanisms in sickness benefits (€0.2bn);
- New civil servants rotation policy on Public Administration and implementation of a rule of hiring one worker for every two that leave (€0.1bn);
- Increase in oil and tobacco excise taxes (€0.4bn and €0.1bn, respectively);
- Increase of car sales tax and stamp duty (€0.2bn);
- Change in the depreciation accounting standard for corporate assets (€0.1bn).

For 2016, the Government also announced the intention to keep the CIT statutory rate in 21% and reduction of the VAT rate in most restaurant expenses from 23% to 13% from July onwards.

Promotion of equity and income will also be achieved through the phased reversal (25% per quarter) of temporary wage cuts in Public Administration and the partial elimination of the extraordinary surcharge in the PIT (which combined have an estimated impact of €0.9bn).

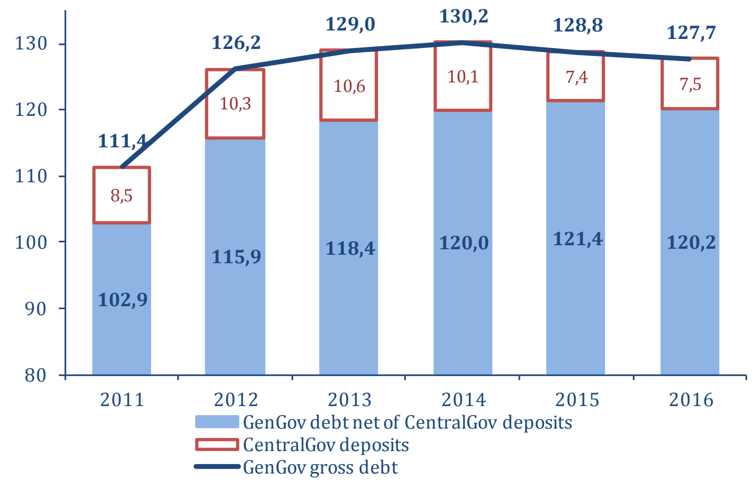
Public debt projected to proceed declining trend

The Maastricht gross debt is expected to decline to 127.7% of GDP in 2016, 1.1pp lower than in 2015 and 2.5pp lower than the peak of 130.2% reached in 2014.

The public debt net of Central Government deposits is expected to decline 1.2pp of GDP to 120.2%, in line with the level observed at the end of 2014.

Public debt is projected to sustain a declining trend, on the back of a solid primary surplus in excess of 2% of GDP and nominal GDP growth of close to 4%

General Government debt (under ESA 2010 rules)
(% GDP)



Source: Banco de Portugal and Ministry of Finance

The decomposition of debt dynamics shows that, for the first time since 2007, the snowball effect will be negative, as the impact of nominal GDP growth is expected to exceed interest costs by 0.2pp of GDP. Together with a primary surplus in excess of 2% of GDP, the public debt would be able to decline more than 2.5pp of GDP.

However, the debt projection points to a more moderate reduction, as the stock-flow adjustment is estimated at +1.5pp of GDP. This is mostly explained by the difference between the budget deficit on a cash and on an accrual basis (the former is projected to be larger by about €1.3 bn), as well as by the inclusion of a credit line in favor of the European Single Resolution Fund (amounting to €0.85 bn) and a marginal increase in the overall Central Government deposits.

Public debt dynamics (pp GDP)

	2014	2015 E	2016 P
Maastricht debt (% GDP)	**130,2**	**128,8**	**127,7**
Change (pp GDP)	1,2	-1,4	-1,1
Primary balance effect	2,3	-0,4	-2,3
Snowball effect	2,5	0,4	-0,2
Interest	4,9	4,7	4,6
Nominal GDP	-2,4	-4,3	-4,8
Other stock-flow adjustments	-3,6	-1,4	1,5

Source: Ministry of Finance

Crucially, the projected downward trend in public debt assumes no favorable inflows from the financial sector. The materialization of any potentially favorable inflows (e.g. from the sale of Novo Banco or the reimbursement of outstanding CoCos) would have a favorable impact in the stock-flow adjustment and thus further reduce the debt stock.

Debt projection considers a conservative scenario in what regards potential proceeds from the sale of financial assets

New estimate of 2016 borrowing needs does not affect financing plan

According to the 2016 Budget, State's net financing needs during the year are projected to stand at €10.2 bn. This is about €3 bn above previous preliminary projections, mainly because the State subsector deficit on a cash basis is about €2.1 bn larger than the GG deficit (which is naturally compensated by large surpluses in other GG subsectors, but not directly reflected in the State's net financing needs). Moreover, the current projection includes a credit line in favor of the European Single Resolution Fund (amounting to €0.85 bn), which will only be drawn in case of new resolution measures are applied.

Gross borrowing needs are estimated at €21.5 bn (or about €19 bn excluding the repurchase of IMF loan still to be executed)

Gross borrowing requirements stand close to €21.5 bn, given MLT debt redemptions of €6.7 bn and assuming €4.6 bn redemptions of IMF loans, of which about €2.0 bn already executed in February.

The financing needs will be covered by:

MLT debt financing is estimated to stand in the initially announced range: 18-20 bn

- MLT debt market issuance (circa €20 bn, of which €5.7 bn have already been raised through the new 10-year PGB benchmark and the 10-year EMTN recently issued); and
- Retail issuance (€1.7 bn, of which €0.5 bn already raised).

State Treasury borrowing needs and sources (€ billion)

	2014 E	2015 E	2016 P	2017 P	2018 P	2019 P
State borrowing requirements	**30,9**	**29,0**	**21,5**	**18,0**	**18,1**	**18,1**
Net financing needs	**14,3**	**11,8**	**10,2**	**7,7**	**5,9**	**6,6**
Overall deficit *	7,1	5,6	6,2	5,0	3,8	3,1
Other net acquisitions of financial assets **	7,6	6,2	4,1	2,6	2,0	3,5
Privatizations (-)	-0,4					
MLT Redemptions	**16,6**	**17,2**	**11,3**	**10,3**	**12,3**	**11,5**
Tbonds (PGB + MTN)	16,6	8,8	6,7	8,8	8,8	11,0
IMF (executed)		8,4	2,0			
IMF (to be executed)			2,6	1,5	3,5	0,5
p.m. IMF (original maturity of outstanding loan)			*0,0*	*0,0*	*1,8*	*4,8*
State financing sources	**30,9**	**29,0**	**21,5**	**18,0**	**18,1**	**18,1**
Use of deposits	**2,8**	**5,8**	**-0,8**	**0,9**	**1,0**	**1,0**
Financing in the year	**28,1**	**23,2**	**22,3**	**17,1**	**17,1**	**17,1**
Executed	**28,1**	**23,2**	**6,4**			
EU-IMF	5,2					
Tbonds (PGB + MTN)	19,9	20,2	5,7			
Tbills (net)	-2,8	-0,7				
Retail debt (net)	5,0	3,5	0,5			
Other flows (net)	0,7	0,2	0,2			
To be executed			**15,9**	**17,1**	**17,1**	**17,1**
Tbonds (PGB + MTN)			14,3			
Tbills (net)						
Retail debt (net)			1,2			
Other flows (net)			0,5			
State Treasury cash position at year-end * **	**12,4**	**6,6**	**7,4**	**6,5**	**5,5**	**4,5**

* State sub-sector cash deficit in 2014-16. Projection for GG deficit in 2017-19 (Government Program, Nov 2015).

** Includes refinancing of other public entities (namely SOEs and regions), as well as ESM participation and redemption of CoCos in 2014, loans to the Resolution Fund in 2014-15, and direct capitalization of Banif in 2015.

*** Excluding cash-collateral.

Source: IGCP

Needs of additional issuance of MLT debt in 2016 effectively amount to €12 bn (assuming a projected increase of the cash buffer to €7.4 bn)

As previously stated, the additional pre-payments on IMF loans still projected for 2016 (€2.6 bn) are dependent on market conditions and the sale of financial assets. Hence, the funding needs to be covered with MLT debt issuance for the remainder of 2016 effectively amount to about €12 bn.

Given a cash position of €6.6 bn at end-2015 (about €2 bn lower than the target set by IGCP, as a result of the recapitalization of Banif close to year-end), IGCP expects to end 2016 with a cash position of €7.4 bn, close to 50% of 2017 borrowing needs, which are projected to stand at €16.5 bn excluding additional IMF loan repurchases.

Annex 1: General Government Accounts 2010-2016 (ESA 2010)

General Government Account (accrual basis)								
(% GDP)	2010	2011	2012	2013	2014	2015 P	2016 P	2016 vs 2015
Total revenue	**40,6%**	**42,6%**	**42,9%**	**45,1%**	**44,5%**	**43,9%**	**43,8%**	**-0,2pp**
Current revenue	39,4%	41,5%	41,1%	44,0%	43,7%	43,3%	42,9%	-0,3pp
Current taxes on income and wealth	8,5%	9,5%	9,0%	11,4%	10,9%	10,9%	10,3%	-0,6pp
Taxes on production and imports	13,2%	13,9%	13,9%	13,7%	14,2%	14,5%	14,9%	0,4pp
Social contributions	11,9%	12,0%	11,4%	12,0%	11,7%	11,5%	11,4%	-0,1pp
Other revenue	5,8%	6,2%	6,9%	6,8%	6,8%	6,3%	6,3%	0,0pp
Capital revenue	1,3%	1,1%	1,8%	1,1%	0,8%	0,7%	0,9%	0,2pp
Total expenditure	**51,8%**	**50,0%**	**48,5%**	**49,9%**	**51,7%**	**48,3%**	**46,0%**	**-2,3pp**
Current expenditure	44,6%	45,6%	45,3%	46,8%	45,7%	44,2%	43,6%	-0,6pp
Social benefits	18,6%	18,9%	19,6%	20,4%	19,7%	19,2%	18,6%	-0,7pp
Compensation of employees	13,7%	12,8%	11,7%	12,5%	11,8%	11,1%	10,9%	-0,2pp
Interest (EDP)	2,9%	4,3%	4,9%	4,9%	4,9%	4,7%	4,6%	-0,2pp
Intermediate consumption	5,9%	6,0%	5,8%	5,6%	5,8%	5,9%	6,2%	0,3pp
Subsidies	0,7%	0,7%	0,6%	0,6%	0,7%	0,5%	0,6%	0,1pp
Other current expenditure	2,8%	2,9%	2,7%	2,7%	2,8%	2,8%	2,8%	0,0pp
Capital expenditure	7,2%	4,4%	3,3%	3,2%	6,0%	4,0%	2,4%	-1,6pp
Gross fixed capital formation	5,3%	3,5%	2,3%	2,3%	2,0%	2,1%	1,9%	-0,2pp
Other expenditure	1,9%	0,9%	1,0%	0,9%	6,8%	4,7%	3,3%	-1,4pp
Overall balance	**-11,2%**	**-7,4%**	**-5,7%**	**-4,8%**	**-7,2%**	**-4,3%**	**-2,2%**	**2,1pp**
Memo items								
Primary expenditure	**48,9%**	**45,7%**	**43,6%**	**45,1%**	**46,8%**	**43,6%**	**41,4%**	-2,1pp
Primary balance	**-8,2%**	**-3,1%**	**-0,8%**	**0,0%**	**-2,3%**	**0,4%**	**2,3%**	**2,0pp**

Source: Statistics Portugal and Ministry of Finance

2016 Budget report (in Portuguese only):

- http://www.dgo.pt/politicaorcamental/Paginas/OEpagina.aspx

European Commission opinion on the Draft Budgetary Plan for 2016 (Feb 5th):

- http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2016/pt_2016-02-05_co_en.pdf

Eurogroup statement on 2016 Budget (Feb 11th):

- http://www.consilium.europa.eu/en/press/press-releases/2016/02/11-eurogroup-statement-portugal/

Further information on the Portuguese economy can be obtained from:

- **Ministry of Finance** www.portugal.gov.pt/en/the-ministries/ministry-of-finance
- **Banco de Portugal** www.bportugal.pt
- **Statistics Portugal** www.ine.pt
- **Public Finance Council** www.cfp.pt
- **UTAO (only in PT)** Website
- **Portugal Economy Probe** www.peprobe.com

Tel: +351 217923300
Fax: +351 217993795
E-mail: info@igcp.pt

Web site: www.igcp.pt
Reuters pages: IGCP01
Bloomberg pages: IGCP