FINANCING AND THE PORTUGUESE GOVERNMENT DEBT MARKET

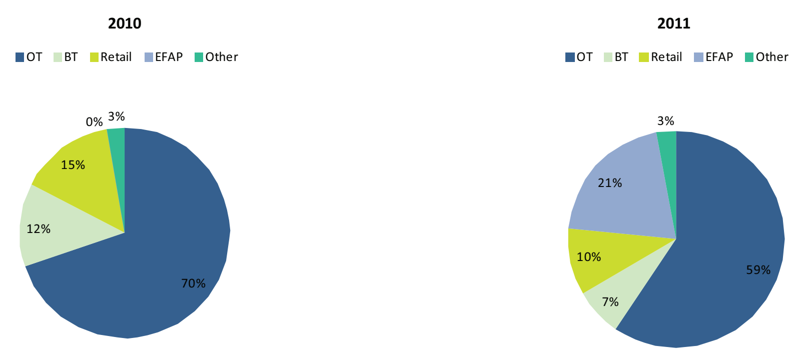
THE PORTUGUESE GOVERNMENT DEBT MANAGEMENT STRATEGY IN 2011

In 2011, the management of Portuguese Government debt was heavily conditioned by the worsening of the sovereign debt crisis and the difficulty in obtaining market funding. The EFAP, which was signed in May 2011, had a profound impact on the borrowing programme defined at the beginning of the year, as most financing needs were met through the loans granted by the EFSM, the EFSF and the IMF.

The funding through medium- and long-term market instruments included the issuance of a new government bond (OT) series in February – the new 5-year benchmark – and the reopening of 4 OT issued in previous years. The funding via Treasury bills (BT) started with the issuance of 12-month lines. However, following the signing of the EFAP, market conditions worsened significantly making it possible to issue only 3- and 6-month lines. Prior to the beginning of the EFAP, 6 new issues were also launched under the Euro Medium Term Notes (EMTN) programme.

Non-marketable instruments – Saving and Treasury Certificates, as well as CEDIC (special certificates of government debt) – had a negative net contribution to the Republic's annual borrowing needs, given the large amount of redemptions of Saving Certificates.

Graph 9 – Debt stock structure by type of instrument



SOURCE: IGCP

BORROWING REQUIREMENTS

On a public account basis, the State's net borrowing requirements in 2011 amounted to EUR 14.3 billion. This figure includes the net purchase of financial assets by the Government as a way to meet the financing needs of some state-owned enterprises (included in the GG consolidation perimeter), which were unable to meet these needs through the market. A Bank Solvency Support Facility was also created, as foreseen in the EFAP, with a total amount of EUR 1 billion.

Table 2 – State borrowing requirements
(unit: EUR million)

	2010	2011 E
1. NET BORROWING REQUIREMENTS	**17,106**	**14,277**
Budget deficit	14,249	7,044
Net purchasing of financial assets (except privatisation revenues)	2,088	6,233
BSSF *	0	1,000
Flows to the FRDP	1,500	0
Privatisation revenue used for debt redemption (-) **	731	0
2. FUNDED REDEMPTIONS	**32,245**	**39,707**
Saving Certificates + Treasury Certificates	1,920	4,820
Short-term euro-denominated debt	21,777	25,321
Medium- and long-term euro-denominated debt	7,709	9,591
Non-euro-denominated debt	1,245	285
Swaps capital flows (net)	-406	-311
3. GROSS BORROWING REQUIREMENTS (1. + 2.)	**49,351**	**53,984**

* Amount held by the Government to set up the BSSF. By the end of 2011 no credit institution had resorted to this fund.

** The EUR 600 million received by the Government in 2011 (when EDP was privatised) was only transferred to the FRDP in 2012. This amount will therefore only be used to redeem government debt in 2012.

SOURCE: DGO and IGCP

FINANCING ACTIVITY

The net issuance of debt in 2011 totalled EUR 21.6 billion. When compared to 2010, OT, BT and Saving Certificates all had negative net contributions of EUR 2.2 billion, EUR 6.8 billion and EUR 4.1 billion, respectively.

Table 3 – Financing composition in 2011
(unit: EUR million)

	Funded issuance		Funded redemptions		Net financing	
	Amount	Structure	Amount	Structure	Amount	Structure
Euro-denominated debt	**48,134**	**78.5%**	**39,732**	**100%**	**8,402**	**39%**
CA	371	0.6%	4,457	11.2%	(4,086)	-18.9%
CT	986	1.6%	363	0.9%	623	2.9%
CEDIC	3,933	6.4%	4,887	12.3%	(954)	-4.4%
CEDIM	141	0.2%	-	0.0%	141	0.7%
BT	12,461	20.3%	19,261	48.5%	(6,800)	-31.5%
OT	7,321	11.9%	9,491	23.9%	(2,169)	-10.1%
FEEF	7,008	11.4%	-	0.0%	7,008	32.5%
MEEF	14,066	23.0%	-	0.0%	14,066	65.2%
Other debt	1,847	3.0%	1,273	3.2%	574	2.7%
Non-euro-denominated debt	**13,147**	**21.5%**	**285**	**0.7%**	**12,862**	**59.6%**
IMF	13,147	21.5%	-	0.0%	13,147	60.9%
Other debt	0	0.0%	285	0.7%	(285)	-1.3%
Swaps (Net)			(311)		311	1.4%
Total	**61,281**	**100%**	**39,707**	**100%**	**21,574**	**100%**

SOURCE: IGCP

The loans under the EFAP had a positive contribution to meet the year's borrowing needs, replacing medium- and long-term funding through the market. Additional data on market funding and via EFAP is shown below.

Financing under the EFAP

Disbursements of the EFAP in 2011 amounted to EUR 34.2 billion.

Table 4 – Tranches disbursed under the EFAP

	Amount disbursed (EUR million)	Nominal value (EUR million)	Average maturity (years)	Weighted average rate (%)
EFSF (long-term) *	6,026	7,128	8.4	4.0%
EFSF (short-term) **	985	986	0.2	2.5%
EFSM	14,063	14,100	8.9	2.9%
IMF ***	13,147	13,147	7.3	5.3%
TOTAL	**34,221**	**35,360**	**7.9**	**4.0%**

* The difference between the amount disbursed and the nominal value results from the payment of an upfront margin of 2.08 per cent in the 1st tranche of the loan disbursed in June 2011. The cost of funding estimated here assumes the repayment of this amount at the end of the loan.

** The EFSF short-term loans will be refinanced for a longer period of up to 15 years. The interest rate shown takes into account service fees that will not occur on the refinancing dates of these loans.

*** Financing cost of the IMF loan estimated using forward rates.

SOURCE: IGCP

The EFSM agreed to eliminate a 2.15 per cent spread in all disbursements, with retroactive effects to the loans granted in May and June of 2011. The EFSF also agreed to eliminate this margin but only for the disbursements which took place after December 2011. The spread of the loans granted in June 2011 was used to build up a cash-buffer initially and will be returned only after the redemption of the loans. The financing cost of the IMF loans follows from that of a currency basket. Therefore, the weighted average rate shown is merely an estimate, resulting from foreign exchange and interest rate forwards.

OT issuance

Funding through the OT market was expected to reach a minimum of EUR 18 billion, including the launching of new OT series, the reopening of these new OT and of other existing series. However, as this was replaced with loans under the EFAP, OT issuance was only EUR 7.3 billion.

The only new OT series was launched in February and the expectation of a maximum two new series did not materialise, given the deterioration of market conditions. Through this new series, OT 6.4% February 2016, EUR 3.5 billion were issued with a 5-year maturity.

In addition to this syndicated placement, four OT auctions were held in 2011 where four series were reopened with 2, 4 and 10-year maturities. In total, a nominal amount of EUR 3.8 billion was placed in these auctions.

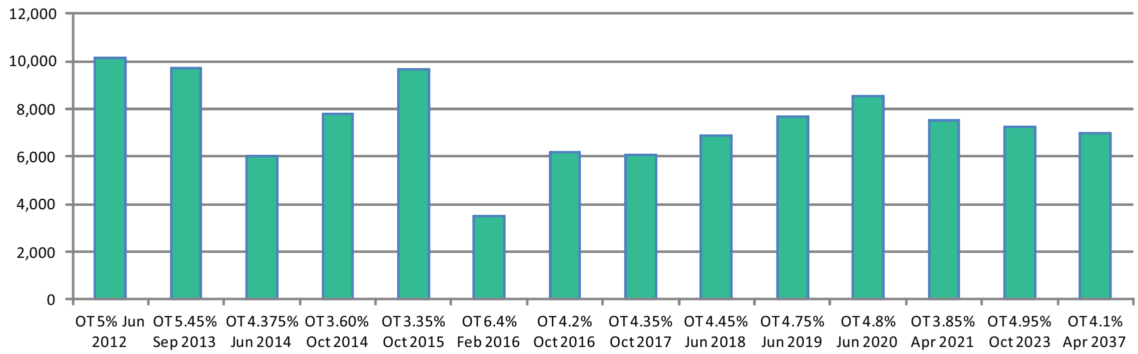
The deterioration of funding conditions is clearly visible in the sharp increase of the weighted average rate and the ASW in Table 5.

Table 5 – Weighted average of OT auctions in 2010 and 2011

Maturity (years)	2		4		10	
Year	2010	2011	2010	2011	2010	2011
Bid-to-cover ratio	2.4	1.5	3.1	2.6	1.9	3.2
Weighted average rate (%)	2.5	5.9	4.1	5.4	5	6.7
ASW (bp)	102	358	204	302	191	312

SOURCE: IGCP

Graph 10 – OT-curve at end-2011 (EUR million)



SOURCE: IGCP

EMTN Programme

Six issues were made under the EMTN Programme. Five of these were denominated in euros and linked to Euribor, four of which had 2, 7, 8 and 10-year maturities and one of which was an 18-months zero coupon. In total, EMTN issues amounted to EUR 1.2 billion.

Issuance of Treasury bills

In 2011 six new BT lines were issued instead of the ten initially foreseen, with maturities between December 2011 and May 2012. Throughout the year 33 auctions were held through which a gross nominal amount of EUR 24.8 billion was placed. As a result of redemptions that totalled EUR 31.6 billion, the nominal contribution of BT to the year's financing was negative in an amount of EUR 6.8 billion.

However, it was initially expected that the net issuance of BT would be marginally positive. This difference was due to the deteriorating market conditions, in particular the lack of demand for 12-year BT. The worsening of market conditions can also be seen in the results of the BT auctions, with the weighted average rate of the issues reaching close to 5.0 per cent levels after the EFAP.

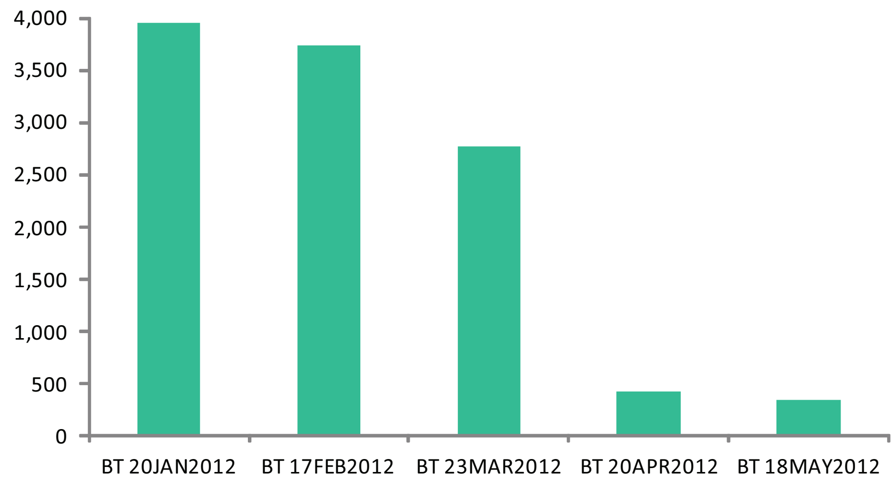
Table 6 – Result of BT auctions in 2010 and 2011

Maturity (months)	3		6		12	
Year	2010	2011	2010	2011	2010	2011
Bid-to-cover ratio	2.6	2.1	2.7	3.6	2.3	2.5
Weighted average rate (%)	1.6	4.9	1.7	4.5	2.3	4.2
ASW (bp)	73	334	63	289	98	248

SOURCE: IGCP

The adverse market conditions also led to a substantial reduction in the international placement of Portuguese debt versus 2010.

Graph 11 – BT curve at end-2011 (EUR million)



Note: Excludes BT issued in favour of the Public Debt Stabilisation Fund.

SOURCE: IGCP

DEBT BUYBACK PROGRAMME

The buyback programme includes issues with a residual term of 12 months or less. Three buyback auctions of OT maturing in 2011 (April and June) were held during the first quarter, through which a total of EUR 325 million was bought back.

Buybacks of OT maturing in April 2011 were also carried out on a bilateral basis in a total nominal amount of EUR 152.5 million.

THE SECONDARY MARKET OF PORTUGUESE GOVERNMENT DEBT

Conditions in the European government bond market deteriorated significantly in 2011. The spreads of most European sovereigns widened significantly in the secondary market, with the exception of German spreads, which continued to narrow.

The countries seen as having the largest macroeconomic unbalances suffered sharp increases in the risk premia of their sovereign debt.

Table 7 – Asset Swap Spreads

	ASW 5Y (b.p.)		ASW 10Y (b.p.)	
	20-12-2011	vs 2010	20-12-2011	vs 2010
Germany	-92	-34	-54	-20
Belgium	169	93	194	124
Spain	261	40	271	49
France	30	53	64	55
Greece	4674	3545	3108	2178
Ireland	663	89	n.a.	-
Italy	433	291	419	268
Portugal	1473	1107	1080	725

SOURCE: Bloomberg

The European Council agreed on a new financial assistance package for Greece in July, conditioned to the involvement of the private sector. It also agreed on a reduction in the cost of funding for countries receiving financial assistance as well as an extension of maturities associated with these loans. It further approved the possibility of secondary market purchases by the EFSF.

In October, a new Summit of Heads of State and Government in the euro area approved the creation of new instruments, which will make it possible to leverage the amount available to Member-States in need of financial assistance.

Nevertheless, the measures agreed so far have proved insufficient to change market sentiment on a permanent basis, given concerns surrounding the implementation of the second financial assistance package to Greece. Without short-term measures with unlimited intervention capacity, the outcome of the Summits, more focused on medium- and long-term measures, have not managed to stabilise market conditions. Markets continue to experience high volatility and widening risk premia and credit default swaps (CDS).

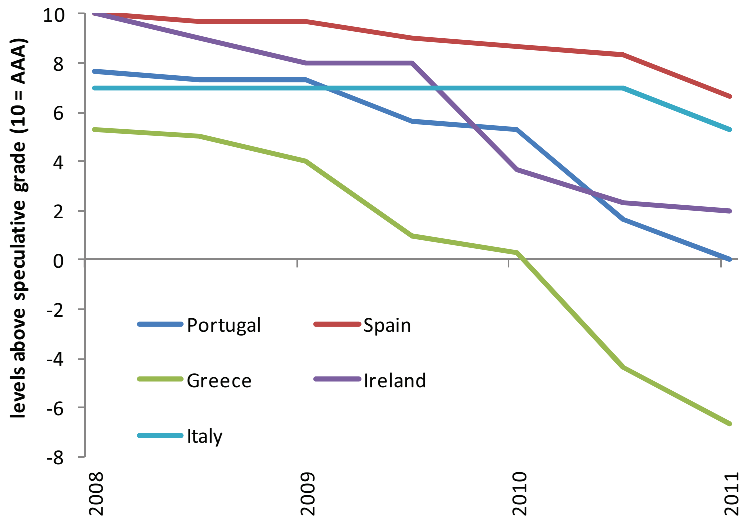
Table 8 – Annual change of CDS

	5Y	10Y
Portugal	595	515
Germany	46	44
Spain	44	164
Italy	263	293
Greece	5145	6017
Ireland	115	30

SOURCE: Bloomberg

This widening throughout 2011 was accompanied by successive downward revisions of ratings.

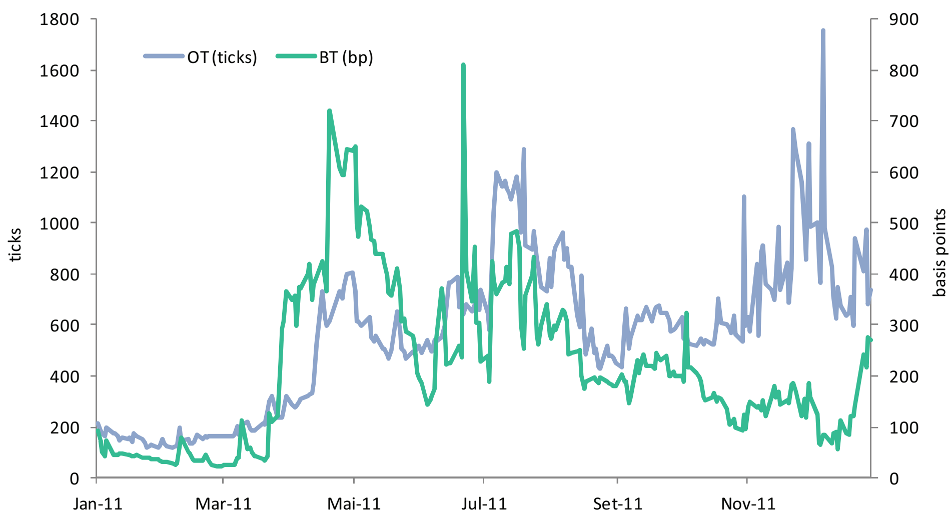
Graph 12 – Ratings in the Euro area (average of the 3 main rating agencies)



SOURCE: Bloomberg

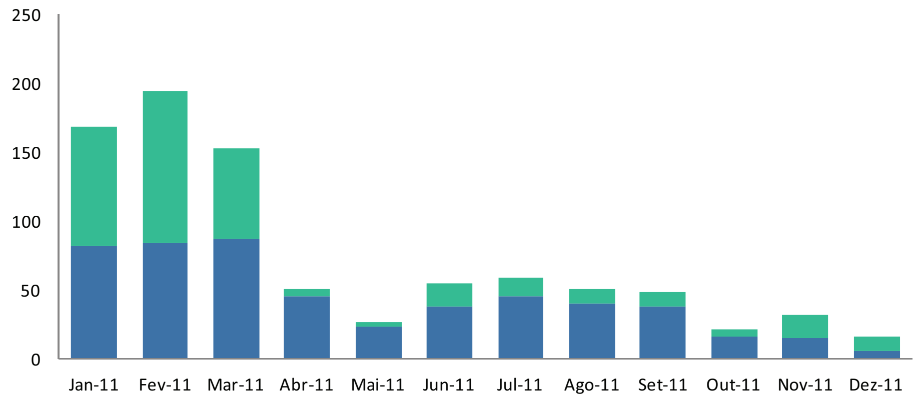
The combination of these factors led to a deterioration of the bid-offer spreads and of market turnover of government debt in the secondary market. Nevertheless, BT bid-offer spreads improved after the signing of the EFAP. This programme may have improved the credit risk perception of this instrument, given that funding is guaranteed until 2013 assuming that quarterly reviews remain positive.

Graph 13 – Bid-offer spreads by type of instrument



SOURCE: MTS, BrokerTec and eSpeed

Graph 14 – Daily average turnover in the secondary market



SOURCE: MTS, BrokerTec and eSpeed

PARTICIPANTS OF THE PORTUGUESE GOVERNMENT DEBT MARKET

Although funding through marketable instruments was limited in 2011, it is important to analyse the performance of primary dealers as a distribution channel in the primary market and as suppliers of reference prices and liquidity in the secondary market.

The group of primary dealers (OEVT) remained unchanged throughout 2011 – with 2 domestic banks in a total of 18 banks. With regard to Treasury bill specialists (EBT), Morgan Stanley joined this group in December 2011. Of the current 18 banks, 4 are domestic.

The table below highlights the performance of OEVT and EBT Specialists.

Table 9 – OEVT and EBT performance

OEVT	
Caixa BI	**1**
BES	**2**
Morgan Stanley	**3**
Goldman Sachs	**4**
Barclays Bank	**5**

EBT	
Caixa BI	**1**
BES	**2**
MBCPI	**3**
SocGen	**4**
Citigroup	**5**