IGCP
Instituto de Gestão da Tesouraria
e do Crédito Público, I.P.

GOVERNMENT DEBT AND CASH MANAGEMENT
ANNUAL REPORT - 2011

2011

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Abbreviations

BdP	*Banco de Portugal*
BSSF	Bank Solvency Support Facility
BT	Treasury Bills
CA	Saving Certificates
CaR	Cost-at-Risk
CDS	Credit Default Swaps
CPI	Consumer Price Index
CEDIC	Special Certificates of Government Debt
CEDIM	Special Certificates of Medium- and Long-Term Government Debt
CSA	Credit Support Annex
DGO	Budget General Directorate
EBT	Treasury Bill Specialist
EC	European Commission
ECB	European Central Bank
EFAP	Economic and Financial Assistance Programme
EFSF	European Financial Stability Fund
EFSM	European Financial Stability Mechanism
EMTN	Euro Medium Term Notes
EU	European Union
FED	Federal Reserve
FRDP	Government Debt Normalisation Fund
GDP	Gross Domestic Product
GG	General Government
HB	Homebanking
HICP	Harmonised Index of Consumer Prices
IGCP	*Instituto de Gestão da Tesouraria e do Crédito Público*
IMF	International Monetary Fund
IRS	Interest rate swaps
ISDA	International Swaps and Derivatives Association
MEDIP	Special Market for Public Debt
MEFP	Memorandum of Economic and Financial Policies
MoU	Memorandum of Understanding on Specific Economic Policy Conditionality
OECD	Organisation for Economic Cooperation and Development
OEVT	Primary Dealers
OMP	Other Auction Participants
OT	Portuguese Fixed-rate Government Bonds
PIDDAC	*Programa de Investimentos e Despesas de Desenvolvimento da Administração Central*
Repos	Repurchase Agreements
RTE	State Treasury Regime
SGP	Stability and Growth Programme

INTRODUCTION

In compliance with its statutory obligation and following a policy of transparency, IGCP publishes its Annual Report on Government Debt and Cash Management. The report provides an overview of its debt and cash management activities carried out in 2011.

Against a backdrop of a deepening sovereign debt crisis, the year 2011 was marked by a request for economic and financial assistance by Portugal, which culminated in the signing of a Memorandum of Understanding with the European Commission and the European Central Bank, and the Memorandum of Economic and Financial Policies with the International Monetary Fund on 17 May. These events forced IGCP to refocus its activity since under the Economic and Financial Assistance Programme (EFAP) its medium- and long-term borrowing needs are covered until September 2013. In this context, there was a significant change in the usual sources of funding, with marketable instruments having a negative net contribution to the year's financing. For the first time, the issuance of Government bonds was suspended after the EFAP was signed. Treasury Bills, whose net issuance was also negative, became the main instrument for market funding, which was refocused in shorter maturities (three and six months). Only in the first quarter of the current year did market conditions make it possible to issue in longer terms. The outstanding of retail instruments (Saving and Treasury Certificates) dropped significantly as a result of a large number of redemptions. In the case of Saving Certificates, this was explained by the widening of the spread against the returns on other investment alternatives in the Portuguese financial system as well as by a greater risk perception. Consequently, at the end of 2011 the debt composition was substantially different than usual with most of the normal components declining, while EFAP loans already account for 20.5 per cent of total.

The extension of the principle of unifying the Government's cash management to non-financial state-owned corporations imposed by the Budget Law led to a significant increase in the number of users of IGCP's systems. It also resulted in greater diversification of the type of users, making it possible to maintain the levels of service and to broaden the range of products offered, namely with the introduction of CEDIM. This instrument makes it possible to invest funds for longer periods, which was particularly adequate to the needs of the entities recently integrated in the Government's cash management. This made it possible to maintain a high level of compliance with the principle of unifying the Government's cash management.

The Board of Directors would like to express its gratitude to the members of the Advisory Board and the Supervisory Committee for their cooperation and commitment to their duties.

Finally, a word of recognition to all staff members for their dedication and diligence, which were paramount to fulfil IGCP's mission in a particularly difficult period.

The Board of Directors

March 2012

STATUTORY BODIES OF IGCP*

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* On the completion date of the Annual Report
** Until 21 July 2011

Box PRIMARY MARKET PARTICIPANTS FOR 2012

OT – Government Bonds

OEVT – Primary Dealers
Banco Espirito Santo, SA
Banco Santander
Barclays Bank, plc
BNP Paribas
Caixa Banco de Investimento, SA
Citigroup Global Markets Limited
Crédit Agricole CIB
Credit Suisse
Deutsche Bank, AG
Goldman Sachs International Bank
HSBC France
ING Bank, NV
Jefferies International Limited
Morgan Stanley & Co International
Nomura International
Société Générale
The Royal Bank of Scotland, plc
UniCredit (HVB)

OMP – Other Auction Participants
BPI, SA
Caixa Central de Crédito Agrícola Mútuo
Commerzbank
Millenniumbcp

BT – Treasury Bills

EBT – Treasury Bill Specialists
Banco Espirito Santo, SA
Barclays Bank, plc
Banco Santander
BBVA
BNP Paribas
Banco Português de Investimento (since March 1, 2012)
Caixa Geral de Depósitos, SA
Citigroup Global Markets Limited
Crédit Agricole CIB
Credit Suisse International
Deutsche Bank, AG
Goldman Sachs International
HSBC France
Jefferies International Limited
Millenniumbcp
Morgan Stanley & Co International Limited
Société Générale
The Royal Bank of Scotland, plc

Box NEW BUDGETARY FRAMEWORK LAW: MULTIANNUAL PERSPECTIVE

Law no. 22/2011 of 20 May introduced significant changes in the Budgetary Framework Law. To begin with, the scope of application of the Budgetary Framework Law was broadened to include all entities comprising the General Government, as defined by the European System of National Accounts.

The new Law was drafted according to the multiannual principle. Pursuant to Article 4, annual budgets now have to comply with a multiannual financial programme. The programmes, measures and projects or activities leading to multiannual costs should be included in this programming, thereby showing total spending, the year's costs and those related to the subsequent three years.

The subsectors of the public administrative sector, as well as the entities integrated in these subsectors, are now subject to the principles of budget stability (Article 10 A) and reciprocal solidarity (Article 10 B). Stability is understood as a balanced or surplus budget according to the European System of National Accounts. Reciprocal solidarity means the obligation by all entities of all subsectors to contribute proportionally to meet the principle of budget stability.

Under the new Law, the annual budget is now subject to the principles and targets established in the Stability and Growth Programme (SGP). Pursuant to Article 12 B, the budget process begins with the revision of the SGP and should include the budgetary and economic policy measures as well as their financial impact, duly justified by an implementation calendar. The revision of the SGP should also include an update of the Multiannual Financial Programme (Article 12 D). This should be submitted each year with the budget law and updated for the subsequent four years.

The Budgetary Framework Law lays down that the cyclically-adjusted budget balance, net of one-off measures, may not be lower than the medium-term target established in the SGP (Article 12 C).

With regard to government funding, the changes introduced by the new Law make it possible to anticipate funding necessary for part of the following year's redemptions. The new Article 16 A sets forth that the limit to the direct overall net indebtedness may increase up to 50 per cent of Government funded debt to redeem in the following year. Should this possibility be used, the indebtedness ceiling of the subsequent year should be reduced by an equal amount. The Government may however increase this limit up to 50 per cent of the redemption of funded debt occurring in the following budget year.

This change brings greater flexibility to the Government debt management strategy by making it possible to choose the best timing to carry out funding operations. The timing may now be adjusted to market conditions and is no longer restricted purely to the borrowing needs of a specific budget year.

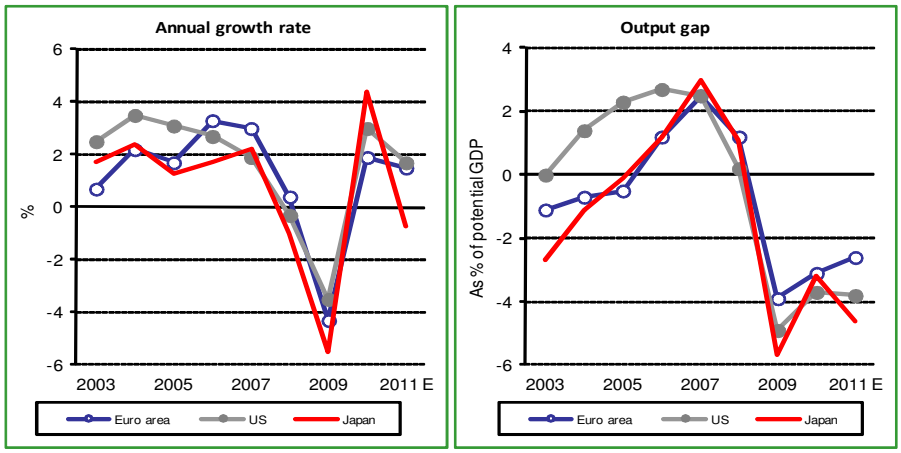
THE ECONOMY AND FINANCIAL MARKETS IN 2011

INTERNATIONAL ENVIRONMENT

The world economy continued to recover in 2011, although according to the IMF[1] the pace of growth decelerated from 5.2 per cent to 3.8 per cent in 2010. While most emerging economies grew briskly (6.2 per cent), a large number of advanced economies experienced a more modest recovery (1.6 per cent). Several reasons were behind this deceleration, including the earthquake in Japan, the oil supply shocks as well as the credit squeeze resulting from the necessary deleveraging of the banking sector and the sovereign debt crisis in some euro area countries. These factors constrained domestic demand with negative consequences in the economic activity of these countries.

Growth decelerated in major world economies in 2011. In the US, economic activity gained 1.7 per cent, 1.3 percentage points less than in 2010, while in the euro area GDP growth dropped 0.4 percentage points to 1.5 per cent. In Japan, GDP contracted 0.7 per cent, following a robust 4.4 per cent growth in 2010. According to OECD estimates, the output gap remained significantly negative in these three economies in 2011, at -2.6 per cent in the euro area, -3.8 per cent in the US and -4.6 per cent in Japan.

Graph 1 – Real GDP growth



SOURCE: European Commission and OECD

The breakdown of US growth according to the expenditure approach shows that only government consumption decelerated in 2011, dropping 2.1 per cent from 0.7 per cent in 2010. Despite the drop in government consumption, domestic demand had a positive contribution to GDP growth of 1.7 percentage points. The contribution of net exports was practically nil, although it was nonetheless an improvement from the previous year's negative contribution of 0.5 percentage points. This was a result of the 6.7 per cent growth in exports, which was not enough to compensate a 4.9 per cent gain in imports.

In the euro area, both private and public consumption decelerated from 1.0 and 0.7 per cent respectively in 2010 to 0.4 and 0.3 per cent in 2011. In turn, investment was up 1.9 per cent, following a 0.3 per cent decline in 2010. In this context, domestic demand added 0.6 percentage points to

[1] IMF, World Economic Outlook Update, January 2012.

growth. Contrary to the US, net external demand in the euro area had a positive contribution to GDP of 0.7 percentage points.

Business and consumer confidence followed a similar path throughout 2011, with indexes declining during the year in both the US and the euro area, signalling a weakening of economic activity in the first months of 2012, especially in the euro area.

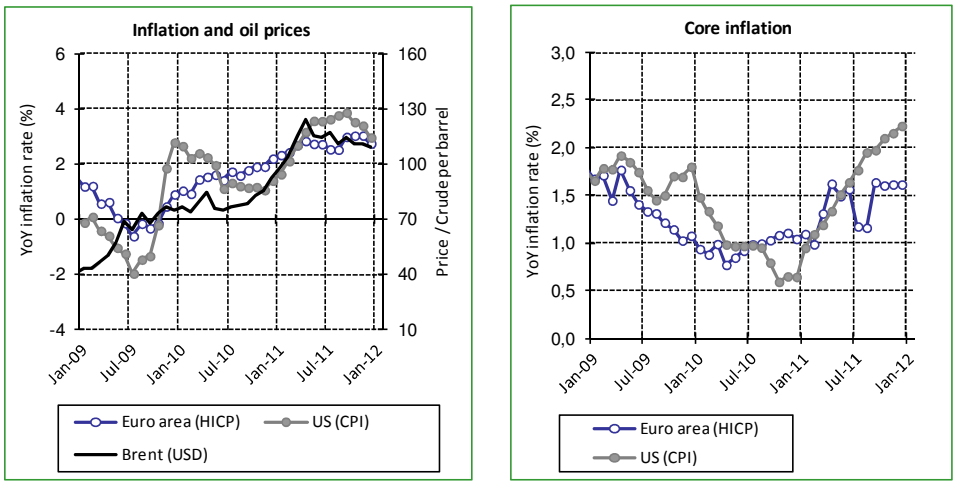
Accordingly, the major international organisations expect the global economic recovery to continue in 2012, albeit at a slower pace than previously expected. In January forecasts, the IMF sees 1.8 per cent growth in the US and 1.7 per cent in Japan while GDP in the euro area is expected to contract by 0.5 per cent.

The unemployment rate dropped in industrialised countries, particularly in the US where it fell from an average 9.6 per cent in 2010 to 9 per cent in 2011 (reaching only 8.5 per cent in December). In Japan, the unemployment rate declined from 5.1 to 4.9 per cent and in the euro area it dropped from 10.1 to 10 per cent. This decline masks very different patterns across euro area countries: while in Germany the unemployment rate was at historically low levels (6.1 per cent), in other countries (such as Greece, Portugal and Spain) unemployment rose sharply.

In the first three quarters, year-on-year inflation accelerated in the US. Year-on-year CPI rose from 1.4 per cent at the end of 2010 to 3 per cent in last three months of 2011, peaking at 3.9 per cent in September. In 2011, the average annual inflation was 3.1 per cent in the US and 2.7 per cent in the euro area, significantly above the 1.7 and 1.6 per cent readings of 2010.

Although the acceleration in inflation was partly explained by the jump in oil prices towards the end of 2010, early 2011, the year-on-year core CPI (which excludes energy and food prices) also accelerated in 2011, from 0.6 per cent at the end of 2010 to 2.2. per cent in December 2011 in the US and from 1 to 1.6 per cent in the euro area.

Graph 2 – Price developments

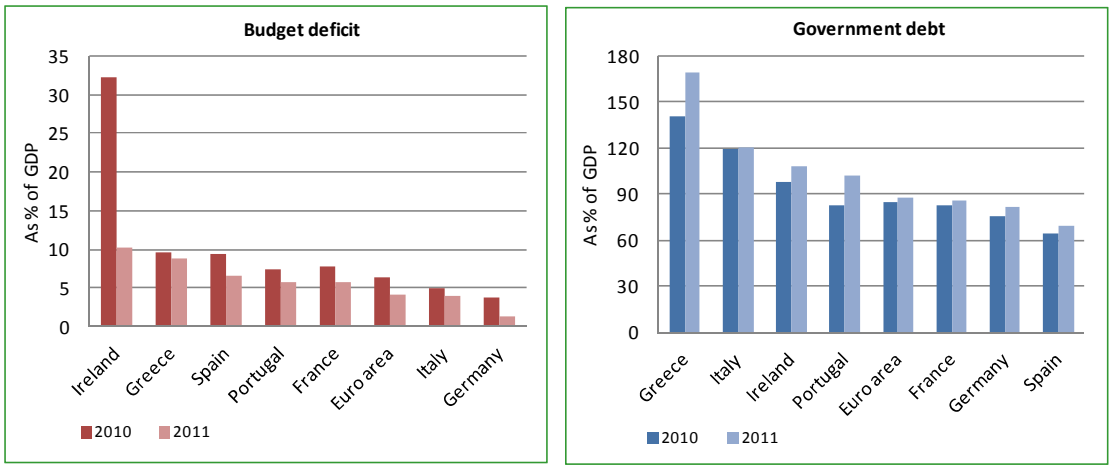


SOURCE: Reuters and Eurostat

The economic and financial crisis and the budget imbalances of some euro area countries made it necessary to adopt budgetary consolidation measures and to rebalance public finances. As a result, the

budget deficit of the euro area narrowed from 6.2 to 4.1 per cent of GDP, according to European Commission estimates[2].

Graph 3 – Budget deficit and Government debt in selected euro area countries in 2010 and 2011



SOURCE: European Commission

The US budget deficit also narrowed from 11.6 to 10 per cent of GDP, although remaining at a relatively high level. In turn, Japan's budget deficit rose from 6.8 to 7.2 per cent in 2011.

The relatively high level of the budget deficit led to a further increase in government debt in advanced economies. In the euro area, government debt reached 88 per cent of GDP in 2011, up from 85.6 per cent in the previous year. In the US, the debt-to-GDP rose from 95.2 to 101.0 per cent while in Japan it climbed from 197.6 to 206.2 per cent.

Against this background, monetary policy maintained an expansionary stance in order to support market liquidity, despite a few changes introduced in 2011. In the first half of the year, the European Central Bank (ECB) expressed concerns with regard to price developments, hiking its repo rate twice by 25 basis points, from 1 per cent in April 2011 to 1.5 per cent in July, with the aim of anchoring inflation expectations in a context of rising energy and other commodity prices. Towards the end of the year, the worsening of the sovereign debt crisis and the deterioration of growth expectations in the euro area led the ECB to loosen monetary policy, by lowering rates to 1 per cent and broadening the liquidity support measures. This included the opening of a 3-year unlimited loan facility.

Throughout the year, the Federal Reserve maintained its view that pressures on core inflation remained contained, with food and energy price increases seen as temporary. Accordingly, the Fed Funds rate was kept unchanged in a range of 0 to 0.25 per cent. In addition, the Fed continued with its Treasury purchase programme, shifting from short-term bonds to longer-term ones, with the aim of pulling long-term interest rates lower.

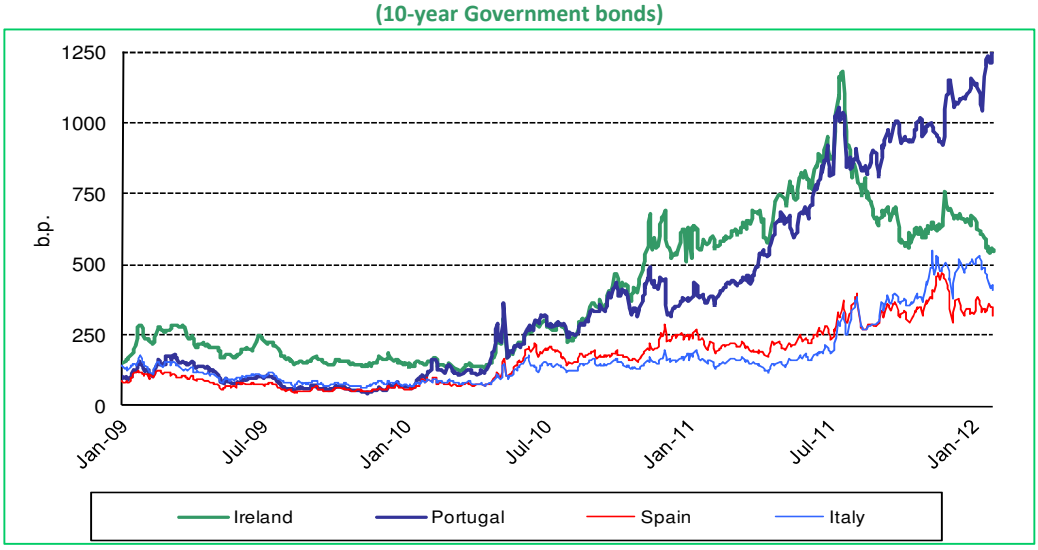
In 2010 and during 2011, the bond market was marked by the sovereign debt crisis in some euro area countries, especially those which ended up requesting financial assistance: Greece, Ireland and Portugal.

[2] European Commission, European Economy, November 2011.

In early 2011, the re-assessment of the sustainability of public finances of several European sovereign issuers had a significant impact in the bond market and the spreads against German Bunds widened substantially in Greece, Ireland and Portugal, especially between February and April. In mid-April, Portugal requested financial assistance. In May, the country agreed on a 3-year Economic and Financial Assistance Programme amounting to EUR 78 billion with the EC, ECB and IMF (see box).

Although spreads narrowed somewhat, following the request for financial assistance, Portuguese government bond yields resumed their upward trend, reaching new highs at year-end.

Graph 4 - Spreads of euro area sovereigns versus the German *Bund*
(10-year Government bonds)

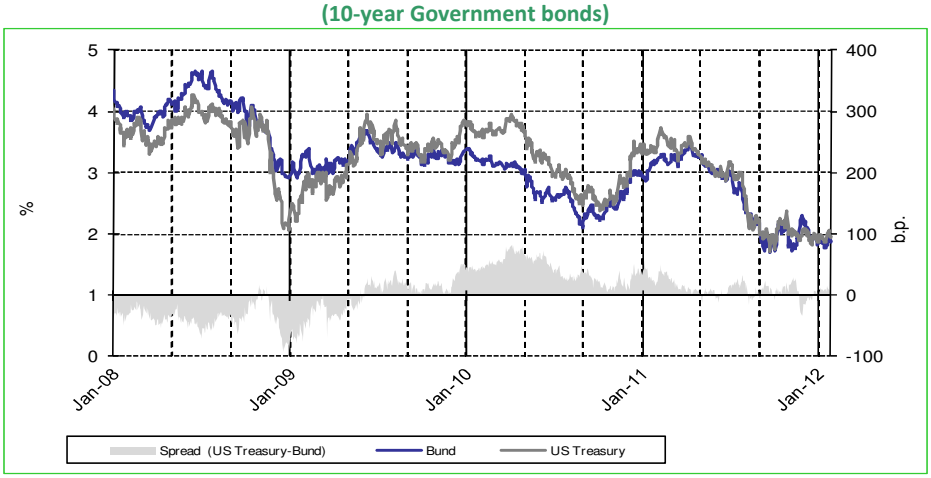


SOURCE: Reuters

Developments in peripheral bond markets were associated with a flight-to-safety to benchmark debt. Ten-year Treasury yields dropped from 3.29 per cent at the end of 2010 to a record 1.72 per cent in September 2011, while 10-year Bund yields fell from 3.0 per cent to around 1.7 per cent in the same period. In both cases, yields fell below the previous records of 2008 and 2010, respectively.

The 10-year spread between Treasuries and Bunds narrowed gradually in the first half of the year, subsequently stabilising at close to nil in the second half.

Graph 5 – Long-term interest rates
(10-year Government bonds)



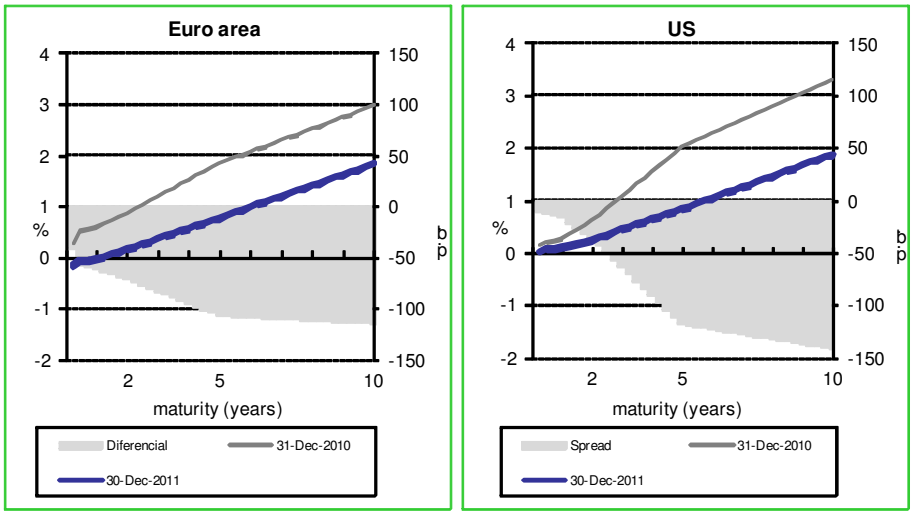
SOURCE: Reuters

In the 2-year segment, Schatz also closely followed Treasuries. Yields in this maturity followed a downward trend in the second semester, reaching a low of 0.16 per cent in the US (in September) and in Germany (in December).

In the short-end of the curve, interest rates plunged even more. In Germany, 3-month Bubill interest rates reached negative territory consistently over the last three months of the year, ending the year at -0.15 per cent. In the US, 3-month Tbill interest rates dropped from 0.13 per cent at the end of 2010 to 0.02 per cent at the end of 2011.

As yields dropped more significantly in the long-end than in the short-end, the yield curve flattened substantially in 2011. In the US, the spread between 10-year Treasuries and 3-year Tbills fell from 316 basis points at the end of 2010 to 186 basis points in December 2011. In the same period, the spread between 10-year Bunds and 3-month Bubills declined from 272 to 198 basis points in the euro area.

Graph 6 – Term structure of interest rates



SOURCE: Reuters

The equity market continued to rally in the first half of the year. However, these gains were offset by heavy losses in the third quarter. As a result, German Xetra Dax loss 14.7 per cent between the end of 2010 and the end of 2011 (following gains of 16.1 per cent in 2010), while in the US, the S&P500 was unchanged and Nasdaq gained 2.7 per cent. This compares to gains of 12.8 and 19.2 per cent respectively in 2010.

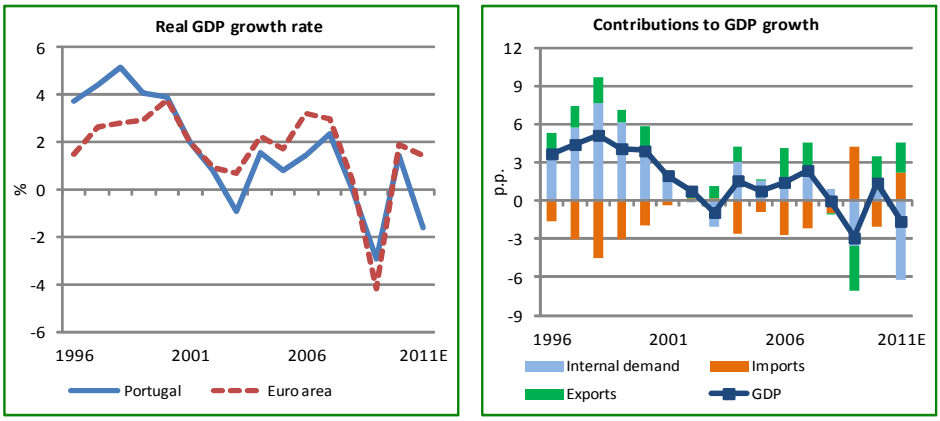
In the foreign exchange market, the euro strengthened against the dollar in the first half of the year. The EUR/USD appreciated from 1.34 at the end of 2010 to a high of 1.48 in May 2011. In the second half of the year, concerns with the sovereign debt crisis and a downward revision of growth led to a depreciation of the single currency, the EUR/USD ending the year at 1.29, down 3 per cent from the end of 2010.

PORTUGUESE ECONOMY

Following a 1.4 per cent growth in 2010, the Portuguese economy contracted by an estimated 1.6 per cent[3] in 2011, further widening the growth divergence between Portugal and the euro area, which started in 2002.

The year 2011 was marked by the deterioration of the sovereign debt crisis in the euro area and the third IMF intervention in Portugal. The market pressure on Portuguese government debt and the disappointing execution of the 2011 budget paved the way for the need to request international assistance from the IMF, the European Commission and the ECB. This gave rise to the Economic and Financial Assistance Programme (EFAP – see box).

Graph 7 – Real GDP and contributions to GDP growth in Portugal



SOURCE: Statistics Portugal and European Commission

The downturn in economic activity, which started in the last quarter of 2010, was further intensified by the fiscal consolidation measures which were subsequently adopted. Private consumption, which accounts for 65 per cent of GDP, dropped 3.9 per cent. Government spending also fell 3.9 per cent, while investment had the strongest decline, plunging 11.4 per cent. Only imports and exports contributed positively to GDP growth (2.2 and 2.4 per cent, respectively). Following consistent losses of market share in the years of 1999 through 2005, exporters have been gaining market share since 2006 and this trend was reinforced in 2011.

As in 2010, net external borrowing needs of the Portuguese economy (current and capital account balances) continued to decline. The current and capital account deficit as percentage of GDP dropped from 8.3 per cent in 2010 to 5.1 per cent in 2011. This was mainly the result of a significant improvement in the goods and services balance, whose deficit fell from 7.2 per cent of GDP in 2010 to 3.9 per cent in 2011.

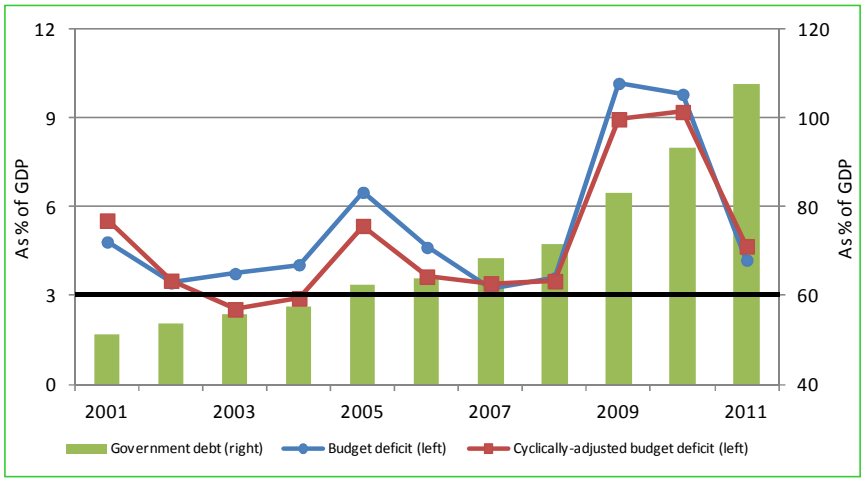
The unemployment rate reached 12.7 per cent of the labour force population in 2011. This average masks a worsening of conditions in the labour market thorough the year, as the unemployment rate increased from 12.4 per cent in the first quarter to 14 per cent in the last quarter. The average unemployment rate was 10.8 per cent in 2010.[4]

[3] Statistics Portugal, Quarterly National Accounts, March 2012.
[4] A new unemployment survey was introduced in 2011, which is not comparable to the one used since 1998. When comparing data from 2010 and 2011, two effects can be identified, one associated with the structure of the new survey and the other related to the deterioration

Portugal's inflation rate, as measured by the annual average change in HICP, was 3.6 per cent in 2011 (which compares to 1.4 per cent in the previous year), 0.8 percentage points above the euro area average. Since April 2008, Portugal's inflation rate has been lower than the euro area average. However, since February 2011 this difference turned positive again. Rising energy prices and the increase in the standard VAT rate in July 2010 and again in January 2011 (in addition to the rise in transportation costs in August and the increase in the VAT rate for electricity and gas in October) contributed decisively to the acceleration of the inflation rate. The price of food and health services also contributed to the rise in inflation.

The General Government (GG) deficit for 2011 is estimated at 4.2 per cent of GDP, well below the 9.8 per cent of 2010 and the 5.9 per cent target set in the EFAP. However, this figure reflects one-off measures, which will not be repeated in 2012 according to the EFAP, such as the partial transfer of pension funds of the banking sector to the social security system. This transfer amounted to the equivalent to 3.5 percentage points of GDP

Graph 8 – Budget deficit and Government debt in Portugal



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

Nevertheless, the year 2011 was marked by a significant adjustment of the structural deficit. Several measures were adopted at the beginning of the year, aimed at cutting spending and increasing tax revenues under the 2011 budget. On the revenue side, these included the reduction of tax benefits in income tax and the rise in the standard VAT rate from 21 to 23 per cent. On the expenditure side, the reduction of an average 5 per cent in nominal wages of civil servants and of workers in the GG perimeter, as well as the cutback in public investment under PIDDAC. As a result, the structural deficit is estimated to have dropped by 4.5 percentage points of GDP, from 11.4 per cent in 2010 to 6.9 per cent in 2011. In 2012, a new reduction to 2.6 per cent is expected.[5]

In spite of the narrowing of the budget deficit, GG debt rose significantly once again in 2011, from 93.3 per cent of GDP at the end of 2010 to 107.8 per cent at the end of 2011. This increase is partially explained by the increase in the Government cash position (approximately 6 percentage points).

of economic activity. According to tests conducted by the Statistics Portugal, the new questionnaire and the method of gathering data tend to generate a reduction in the labour force and employed population and an increase in the unemployed population, thereby raising the unemployment rate. Statistics Portugal estimates that the difference between these two methodologies accounts for a 1.1 percentage point difference in the unemployment rate of the first quarter of 2011.

[5] Ministry of Finance, January 2012.

Box ECONOMIC AND FINANCIAL ASSISTANCE PROGRAMME (EFAP)

On 17 May 2011, the Republic of Portugal signed a loan agreement with the EC, ECB and IMF amounting to EUR 78 billion. This loan will be granted by the European Financial Stability Mechanism (EFSM), the European Financial Stability Facility (EFSF) and the IMF, each contributing with EUR 26 billion.

The Economic and Financial Assistance Programme (EFAP) is based on three pillars:

1. Budget consolidation. This first pillar is aimed at restoring confidence and credibility in public finances. The quantitative targets include the narrowing of the budget deficit to 3.0 per cent of GDP in 2013 and the inversion of the upward trend of the debt-to-GDP ratio.

In order to meet these goals, while minimising the negative impact on economic activity, the Programme foresees that 2/3 of the adjustment be made on the expenditure side.

Table 1 – Budgetary consolidation

Budgetary consolidation strategy (as % of GDP)						
	2011	**2012**	**2013**	**2014**	**2015**	**2016**
Budget Balance	-5.9	-4.5	-3.0	-2.3	-1.8	-1.8
Primary Balance	-1.6	0.7				
Debt of the PA	106.4	112.2	115.3	115.0	112.9	111.0
Impact of the measures taken (as % of GDP)						
Revenue	2.0	0.9	0.5			
Expenditure	3.7	2.1	1.4			

SOURCE: State Budget Report 2012

2. A structural reform agenda. This pillar is aimed at increasing competitiveness in the Portuguese economy by correcting inefficiencies in several sectors. The main reforms include:

i. Liberalisation of the electricity, gas, transportation and telecommunication sectors;
ii. The end of golden shares and special rights;
iii. A privatisation programme, through which a total revenue of EUR 5 billion is expected to be obtained;
iv. Reforms of the judicial system and of the labour market;
v. Restructuring of the state-owned enterprises sector, reducing the number and the operational costs of state-owned companies;
vi. Rationalisation of public-private partnerships;
vii. Simplification of public administration services.

3. Reinforcing financial stability. The third pillar is aimed at preventing the adjustment process, namely the correction of the high external indebtedness, from resulting in a loss of confidence in the banking sector. With this view in mind, the following measures are foreseen:

i. Controlled deleveraging of the banking sector;
ii. Increase of the capital requirements;
iii. Creation of a bank solvency support facility of EUR 12 billion under the EFAP;
iv. Increase of government guarantees to bank debt issues.

To date, three missions comprising members of the three international organisations involved in the programme were in Portugal to monitor compliance with the quarterly targets established. According to the reviews carried out so far, the implementation of the programme was considered to be on track. In this context, Portugal received in 2011 several tranches of the total loan, which totalled approximately EUR 34 billion. The all-in-cost of these operations is estimated at approximately 4 per cent (see details in the following chapter).

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.

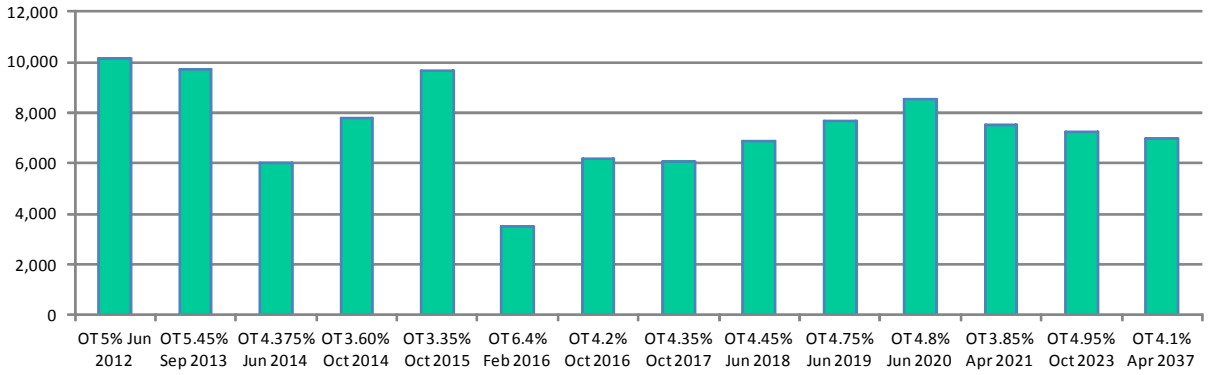
The deterioration of funding conditions is clearly visible in the sharp increase of the weighted average rate and the ASW in Table 5.

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.

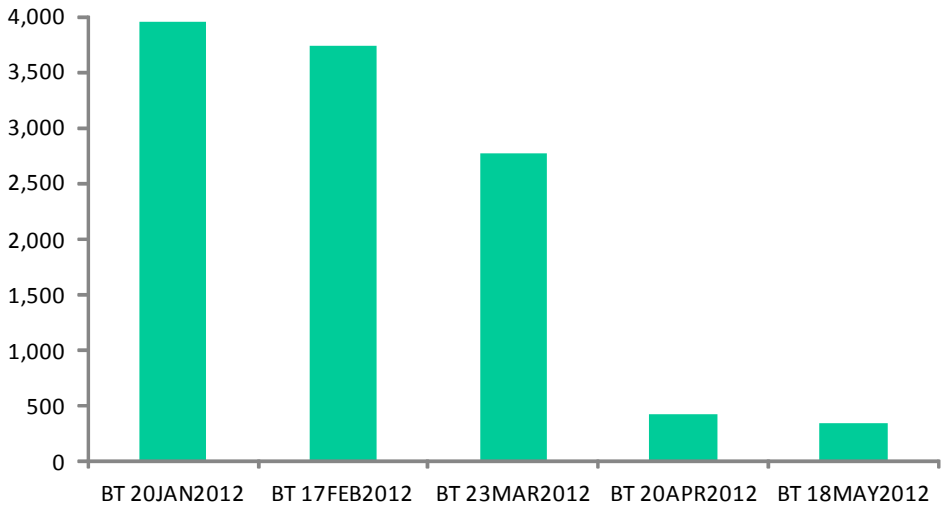
Table 6 – Result of BT auctions in 2010 and 2011

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).

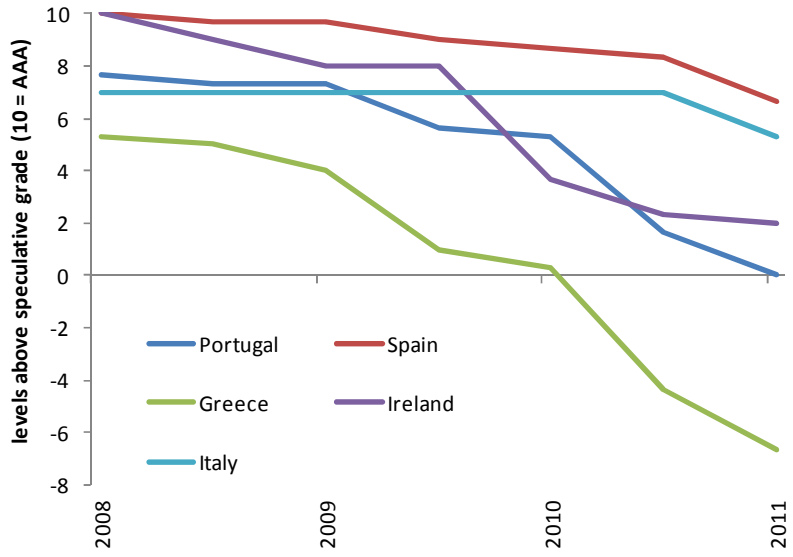
Table 8 – Annual change of CDS

	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.

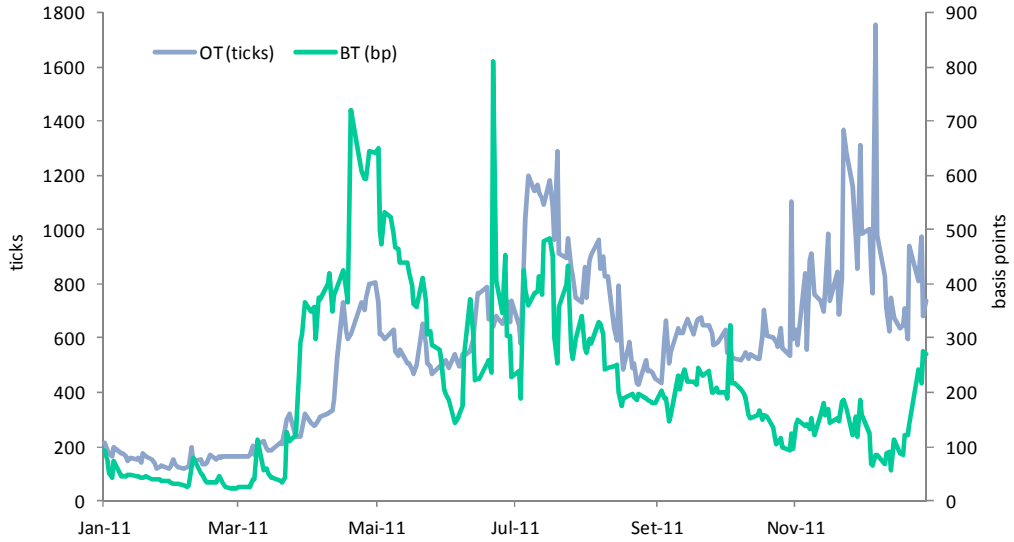
Graph 12 – Ratings in the Euro area (average of the 3 main rating agencies)



SOURCE: Bloomberg

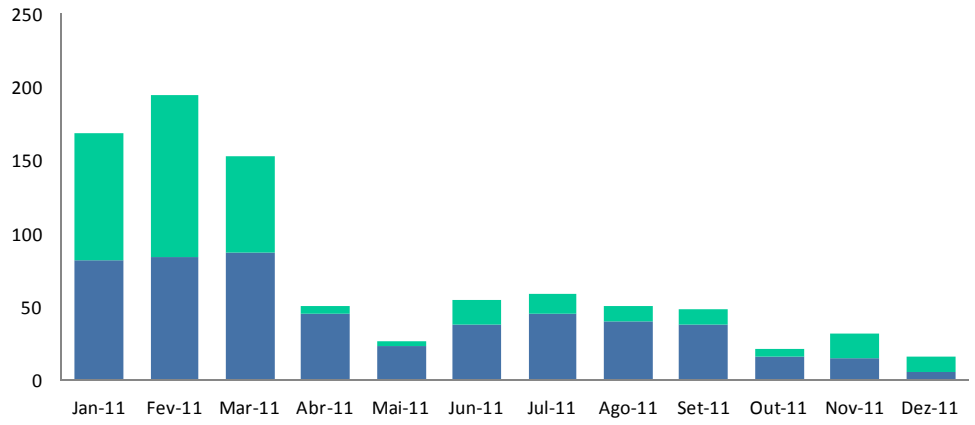
The combination of these factors led to a deterioration of the bid-offer spreads and of market turnover of government debt in the secondary market. Nevertheless, BT bid-offer spreads improved after the signing of the EFAP. This programme may have improved the credit risk perception of this instrument, 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**

FINANCING, CASH AND ACTIVE DEBT MANAGEMENT OPERATIONS

OPERATIONS WITHIN THE FRAMEWORK OF THE REPO FACILITY

In order to promote liquidity and increase the efficiency of the Portuguese government debt market, IGCP provides market makers in MEDIP/MTS Portugal with a repo window of last resort for OT and BT quoted in this market.

Within the framework of this facility, the number of operations carried out and their volume fell sharply in 2011. In total, there were 19 operations – 5 involving BT and 14 involving OT – compared to 217 operations in 2010 (98 involving BT and 119 involving OT). In terms of nominal value, EUR 613.5 million were traded (versus EUR 8,379.5 million in 2010). In terms of collateral, EUR 505 million of OT were traded in comparison to the EUR 5,929.5 traded in the previous year. In the case of BT, the nominal value traded amounted to EUR 108.5 million versus EUR 2,450 million in 2010.

ACTIVE DEBT MANAGEMENT OPERATIONS

In order to enhance the performance of the debt portfolio, the management of market risk is carried out using derivative instruments, primarily plain-vanilla interest rate swaps (IRS). With regard to IRS (67 per cent of the operations carried out), 2 new operations and 11 unwindings were negotiated.

In total, the nominal amount of contracts involving derivative instruments was EUR 9,024 billion.

Table 10 – Transactions with financial derivatives

	New contracts		Early redemption		Total	
Instrument	No. Trans.	EUR Million	No. trans.	EUR Million	No. trans.	EUR Million
IRS	2	500	11	5,600	13	6,100
CIRS	8	2,924	0	0	8	2,924

SOURCE: IGCP

At the end of 2011, the nominal value of outstanding contracts in the derivatives' portfolio amounted to EUR 38.4 billion, equivalent to 22 per cent of the total outstanding of the State direct debt.

Table 11 – Financial derivatives portfolio as at 31.12.2011
(unit: EUR million)

Swap type	Pay leg	NV Total	0-2Y	2-5Y	5-10Y	10-15Y	+15Y
SWAPTION	Fix	0	0	0	0	0	0
	Float	500	0	0	0	0	500
CIRS	Fix	211	0	211	0	0	0
	Float	4,579	348	1,888	2,343	0	0
IRS	Fix	19,100	9,600	6,550	1,650	1,300	0
	Float	13,981	650	2,000	9,451	1,880	0
TOTAL		**38,371**	**10,598**	**10,649**	**13,444**	**3,180**	**500**

CASH MANAGEMENT OPERATIONS

Just as in 2010, in 2011 it was not advisable to pursue the goal of maintaining cash balances at relatively low levels. Cash balances were therefore significantly higher than in previous years. Throughout 2011, the average daily cash balance amounted to EUR 8,379 million, in comparison to EUR 3,218 million in the previous year.

Persistent cash surpluses, excluding those held with *Banco de Portugal*, were invested in short-term deposits, with an average term of 15 days and an average amount of approximately EUR 350 million.

CASH MANAGEMENT

STATE TREASURY ACCOUNTS

Payments and receipts of public institutions made through IGCP's cash management give rise to liabilities and cash balances. The following tables offer an overview of these balances.

The table below shows the evolution of the cash accounts, whose movements are directly reflected in the Government's single Treasury account with *Banco de Portugal*.

Table 12 – Central Government cash balances
(unit: EUR million)

	2009	2010	2011
	Dec	Dec	Dec
Accounts with *Banco de Portugal*	2	1	4,743
Financial investments at credit institutions	884	1,884	7,567
Foreign-exchange accounts	11	16	21
Consular accounts	4	4	4
Receipt accounts IGCP-Single Collection Document	137	113	70
Other bank accounts	4	3	4
Cash accounts with credit institutions			
Customs	346	138	88
Local tax services	90	88	104
Treasury cash accounts			
Customs	3	282	265
Local tax services	50	41	31
Treasury cash accounts			
CTT (postal services)	35	40	25
SIBS	9	10	17
IRN	2	3	2
Foreign-exchange deposits with credit institutions	8	13	6
Outstanding cheques	4	1	1
TOTAL	**1,590**	**2,638**	**12,948**

SOURCE: SGT – Current Account System

As shown in the table above, the Treasury cash accounts essentially cover a group of public services which collect funds, holding only the amounts collected daily. Also relevant are the accounts supporting foreign currency cash management, the balances of which reflect the last movements of the year.

To monitor the evolution of third party cash accounts, the number of public institutions subscribing the Homebanking (HB) system is taken as a reference, since this system is the most frequently used to comply with the principle of centralized cash management, established by the State Treasury Regime (RTE), approved by Decree-Law No. 191/99, of 5 June.

The table below (number of institutions and accounts with HB) shows the use of cash management services by public institutions falling under the RTE, via the number of institutions and accounts with HB, which offers online access to the accounts of these institutions.

Table 13 – Number of institutions and accounts with HB

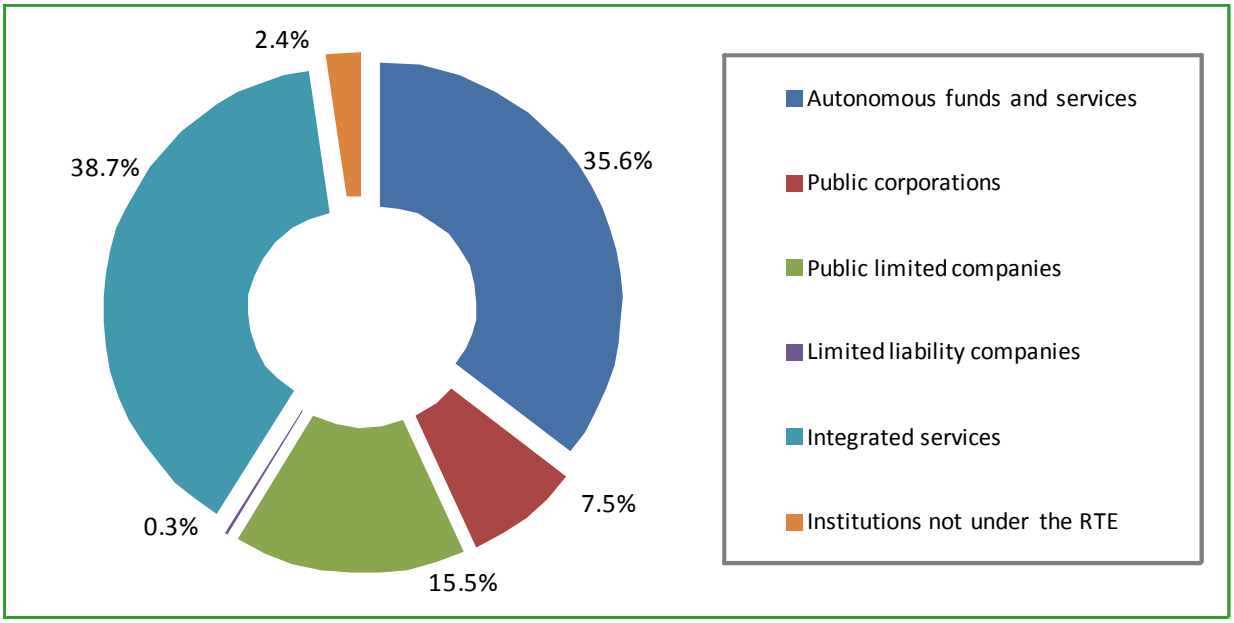
Years	Institutions	No. Accounts
2007	755	3,498
2008	744	3,697
2009	688	3,526
2010	636	3,355
2011	736	3,556

SOURCE: Homebanking

Under article 77 of Law No. 55/2010 of 31 December, which obliged non-financial sate owned enterprises to comply with the RTE, in 2011 the number of institutions using HB grew by 15.7 per cent in relation to 2010, reversing the downward trend of the previous year.

The graph below shows the weight of each of IGCP's clients in the total number of public institutions using HB in 2011.

Graph 15 – Institutions using HB in 2011



SOURCE: Homebanking

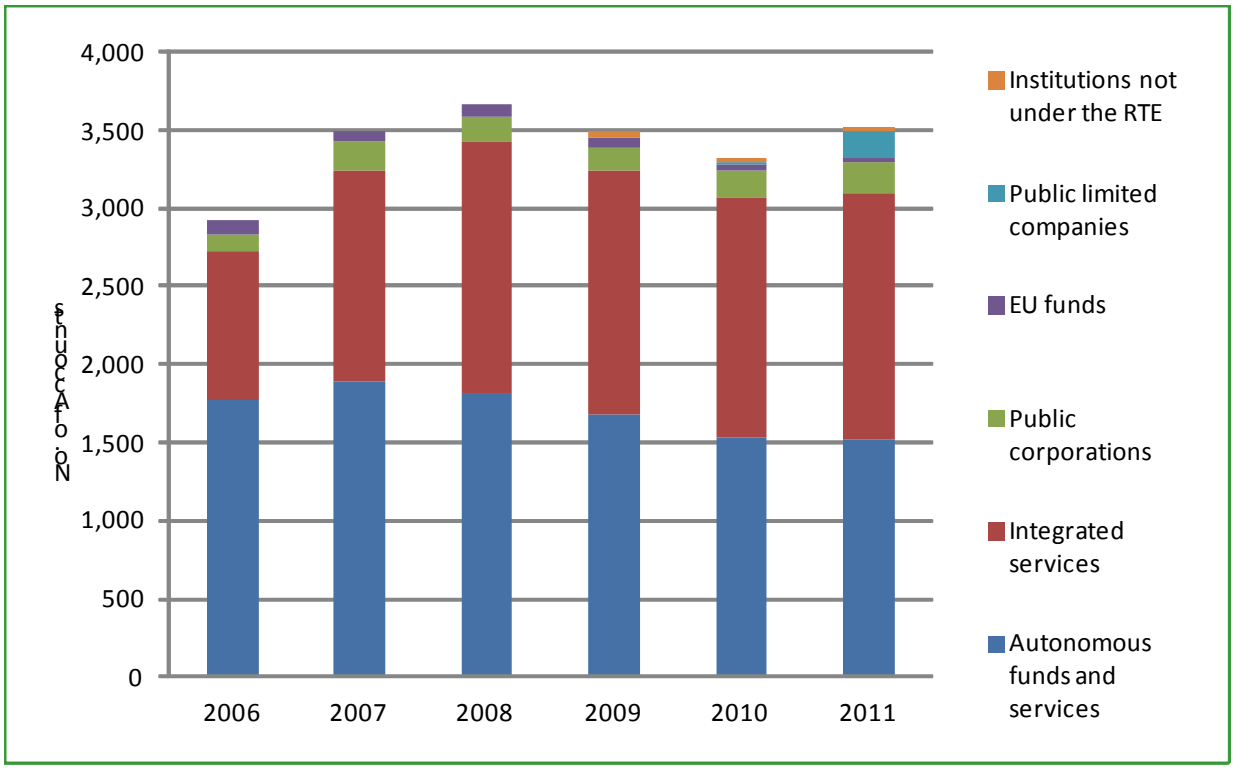
Against this backdrop, Integrated Services and Autonomous Funds and Services continue to be the biggest users of cash management services, representing over 70 per cent of HB users. However, the relative weight of these services in the total number of users of this online application to manage financial flows dropped around 7 and 6 percentage points, respectively, when compared to the previous year. This situation reflects the restructuring measures introduced in recent years.

The number of accounts of Institutions not under the RTE and of public corporations remained stable, representing 2.43 and 7.55 per cent respectively of the total number of HB accounts.

In 2011, the weight of public limited companies increased from 2.0 per cent in 2010 to 15.5 per cent, which explains the positive change in the number of institutions using the Treasury accounts.

The table below illustrates the developments in the number of bank accounts, by client type, in use by public institutions subject to the RTE.

Graph 16 – Number of accounts with HB by type of institution



SOURCE: Homebanking

In 2011, the integrated services had the largest number of bank accounts (accounting for 44.6 per cent of total HB accounts).

Autonomous funds and services, which in 2010 had the greatest number of funds invested with IGCP, dropped to second place in 2011 (representing 43.4 per cent of the total number of HB accounts). These two services have in fact been moving in opposite directions. While autonomous funds and services have reduced the number of bank accounts in use, the integrated services have increased their accounts. In 2011, the difference between the two was 44 accounts.

The number of accounts of public corporations remained stable in 2011, representing 5.5 per cent of the total number of accounts with HB.

The biggest change in 2011, which contributed to the increase in the total number of accounts (6 per cent) in comparison to 2010, was due to the public limited companies, which opened more than 150 accounts between 2010 and 2011, thus complying with the provisions of the Budget Law.

The figures of 2011 therefore reveal the emergence of a new group of clients – public limited companies – as HB users. This can be seen in the table below in the surpluses at the end of 2010 and 2011.

Table 14 – Investment of cash balances – 2010/2011

TYPE OF INSTITUTION	Deposits		CEDIC		CEDIM		TOTAL	
	2010	2011	2010	2011	2010	2011	2010	2011
Autonomous funds and services	2,041	2,276	4,048	3,190	0	10	**6,089**	**5,475**
Public corporations	441	346	434	461	0	23	**875**	**830**
Public limited companies	3	289	4	183	0	108	**7**	**580**
Integrated services	845	1,155	0	0	0	0	**845**	**1,155**
Community manager	16	8	0	0	0	0	**16**	**8**
European Union	163	101	0	0	0	0	**163**	**101**
TOTAL	**3,510**	**4,175**	**4,486**	**3,834**	**0**	**141**	**7,996**	**8,149**

SOURCE*:* Homebanking

As observed, autonomous funds and services still have the greatest number of funds invested with IGCP, although their weight continues to decrease every year (79 per cent in 2009, 76 per cent in 2010 and 67.2 per cent in 2011). At the end of 2011, both cash surpluses and the amounts held in current accounts were lower than in the previous year, dropping by around EUR 600 million.

At the end of 2011, the cash surpluses of integrated services represented 14.2 per cent of funds held with IGCP, having gone up by around EUR 310 million between 2010 and 2011, thus reversing the downward trend since 2008.

Although in 2011 public corporations accounted for 10.2 per cent of funds invested with IGCP, these companies decreased their cash surpluses held with IGCP by approximately EUR 46 million in comparison to 2010.

In 2011, public limited companies had a weight of 7.1 per cent of the total amount invested with IGCP, showing an increase of EUR 570 million in surpluses invested between 2010 and 2011. It should be noted that 76.5 per cent of the subscriptions of CEDIM (the new financial instrument created by IGCP in 2011) were made by these institutions.

In global terms, the amounts invested in the Treasury accounts in 2011 increased by around 2.0 per cent, corresponding to EUR 154 million more than in 2010. Public limited companies played a major role in this increase.

The table below shows the breakdown of cash flows for 2009-2011 specifying, due to its particular nature, the European Union's account, which reflects cash transfers between Portugal and the EU resulting from Portugal's contribution to the EU budget and the EU matched funding for financing or co-financing of structural funds.

Table 15 – Transfers between Portugal and the European Union
(unit: EUR million)

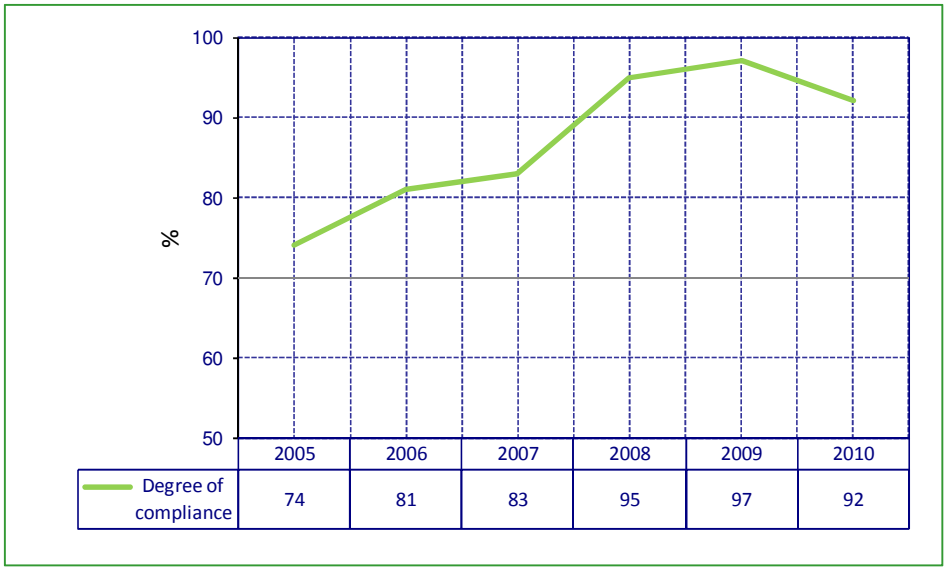
	2009	2010	2011
1. Transfers from Portugal to the EU	**1,596**	**1,802**	**1,762**
Agriculture and customs duties	117	131	144
VAT own resources	236	276	271
GNP-based own resources	1,267	1,360	1,257
UK compensation	128	78	93
Other transfers	1	4	5
Returns and reimbursements/Miscellaneous	-153	-47	-8
2. Transfers from the EU to Portugal	**3,583**	**4,142**	**4,492**
EAGGF-guarantee/EAGF	724	737	750
ERDF	965	1,528	1,803
ESF	1,010	905	1,143
EAGGF guidance	109	0	36
EAFRD	236	452	487
FIFG	24	3	0
EFF	-	30	19
Cohesion fund	457	455	161
Miscellaneous	59	31	93
Total balance (2-1)	**1,987**	**2,340**	**2,730**

SOURCE*:* Homebanking

According to the table above, Portugal has received more from the EU than its contributions to the EU. In the period considered, 2011 was Portugal's most favourable year.

In view of the changes that took place in 2011, it is expected that both HB users and the respective financial flows in the Government's cash management will be consolidated and that the rate of compliance with the principle of centralised cash management will remain above 90 per cent.

Graph 17 – Degree of compliance with the principle of centralised cash management



DIRECT GOVERNMENT DEBT AND COSTS

STATE'S DIRECT DEBT OUTSTANDING

The nominal amount of the State's direct debt outstanding on 31 December 2011, evaluated at end-of-period exchange rates, amounted to EUR 174,891 million (on a public account basis). Taking into account the effect of exchange rate hedging operations, the debt outstanding totalled EUR 174,522 million.

Table 16 – Direct Government debt
(public account basis; unit: EUR million)

	Outstanding		January - December 2011			Outstanding	
	31 Dec 2010	Structure	Issues	Redemptions	Others	31 Dec 2011	Structure
1. Euro-denominated debt (excluding external aid)	**149,436**	**98.5%**	**87,292**	**99,969**	**164**	**136,922**	**78.3%**
Marketable	127,015	83.7%	36,634	44,249	164	119,564	68.4%
ECP (discounted value)	394	0.3%	3,284	3,072	0	605	0.3%
Treasury Bills (BT - discounted value)	19,261	12.7%	24,787	31,587	0	12,461	7.1%
Fixed-rate Government Bonds (OT)	105,946	69.8%	7,321	9,491	163	103,940	59.4%
Other bonds	51	0.0%	0	0	0	51	0.0%
MTN	1,350	0.9%	1,242	99	1	2,493	1.4%
Retail bonds	13	0.0%	0	0	0	13	0.0%
Non-marketable	22,420	14.8%	50,658	55,720	0	17,358	9.9%
Saving Certificates	15,471	10.2%	371	4,457	0	11,384	6.5%
Subscription value	9,150	6.0%	76	2,645	0	6,582	3.8%
Accrued interest	6,320	4.2%	294	1,812	0	4,803	2.7%
Treasury Certificates	685	0.5%	986	363	0	1,308	0.7%
CEDIC	4,887	3.2%	36,844	37,798	0	3,933	2.2%
CEDIM	0	0.0%	141	0	0	141	0.1%
Others	1,377	0.9%	12,316	13,101	0	592	0.3%
2. Non-euro-denominated debt (excluding external aid)	**2,340**	**1.5%**	**1,643**	**1,928**	**52**	**2,106**	**1.2%**
Marketable	2,339	1.5%	1,633	1,918	52	2,106	1.2%
ECP (discounted value)	404	0.3%	1,633	1,918	-23	96	0.1%
Other bonds	165	0.1%	0	0	5	170	0.1%
MTN	1,771	1.2%	0	0	69	1,840	1.1%
Non-marketable	0	0.0%	10	10	0	0	0.0%
3. EFAP	**0**	**0.0%**	**34,221**	**0**	**1,641**	**35,862**	**20.5%**
EFSF / FEEF	0	0.0%	7,012	0	1,101	8,113	4.6%
EFSM / MEEF	0	0.0%	14,063	0	37	14,100	8.1%
IMF / FMI	0	0.0%	13,147	0	502	13,649	7.8%
4. Total debt (1.+2.+3.)	**151,775**	**100.0%**	**123,172**	**101,897**	**1,840**	**174,891**	**100.0%**
5. Exchange rate effect of hedging with derivatives (net)	-74					-369	
6. Total debt after derivatives (4.+5.)	**151,702**					**174,522**	

Note: The outstanding amounts are in nominal value, with the exception of instruments issued at discount (which are at present value), converted at the end-of-month exchange rate, while issues and redemptions are net of premiums and discounts. The "Others" column includes exchange rate fluctuations, premiums or discounts of issues and redemptions and changes in the value of perpetuities.

Excluding the effect of exchange rate hedging, the State's direct debt rose by EUR 23,115 million. This was essentially due to the net issuance of debt instruments in an amount of EUR 21.259 million (the difference between net proceeds and redemptions). The increase in the debt outstanding also reflects other items, such as unfavourable foreign exchange rate changes, in the amount of EUR 554 million, and net discounts on issues and redemptions, which totalled EUR 1,303 million.

The EFAP was the main source of funding with issues totalling EUR 35,360 million in nominal terms. The EFSF and EFSM loans were issued with a net discount of EUR 1,139 million. The IMF loan amounted to EUR 13,147 million, with the depreciation of the euro against the SDR (the currency of IMF loans) leading to a EUR 502 million increase in euro-denominated debt.

In the first four months of the year, fixed-rate government bonds (OT) were also issued by IGCP. A new OT series was launched in February through a syndicate (OT 6.4% Feb 2016) and several other OT series were reopened. In total, a nominal amount of EUR 7,483 million was placed, with net discounts in the order of EUR 162 million.

Debt redemptions, at net proceeds and excluding financial derivatives, amounted to EUR 101,897 million, EUR 61,879 million of which concern debt issued in the same year (floating debt). This figure includes buybacks of debt maturing in the same year in an amount of EUR 2,884 million.

In addition to the above-mentioned effect on the outstanding of the IMF loans, the depreciation of the euro against other currencies also led to a worsening of the swaps portfolio, whose value in euros increased by EUR 52 million.

In turn, the swaps portfolio contributed to the reduction of EUR 295 million in the debt outstanding in euros, after exchange rate hedging, the total debt after swaps increased by EUR 22,820 million.

The breakdown of debt by interest rate type shows that the weight of fixed interest rate in total debt decreased, contrary to the trend seen in the last few years. Excluding the derivatives portfolio, the percentage of fixed-rate debt in total debt dropped from 88.4 per cent to 84.3 per cent in 2011. After swaps, the percentage of fixed-rate debt also dropped to 87.4 per cent from 89.3 per cent at the end of 2010.

In the breakdown of debt by currency before swaps, the share of non-euro debt increased significantly (7.5 percentage points) reaching approximately 9.0 per cent of the debt stock. After swaps, the exchange rate exposure also increased although to a lesser extent. The percentage of non-euro denominated debt rose from close to nil at the end of 2010 to 6.0 per cent at the end of 2011.

In the debt structure by instrument before swaps, the weight of EFAP loans reached 20.5 per cent. Short-term debt accounted for a lower percentage of the annual financing. In 2011, the percentage of short-term debt in the total portfolio dropped 7.2 percentage points to 9.8 per cent. BT had the strongest decline, with their weight falling from 12.7 per cent in 2010 to 7.1 per cent in 2011.

The weight of medium- and long-term OT in the total portfolio fell appreciably (10.4 percentage points) to 59.4 per cent, while the relative importance of Saving Certificates also dropped from 10.2 to a mere 6.5 per cent. Conversely, Treasury Certificates and other medium- and long-term debt saw their weight increase only marginally to 0.7 and 3.0 per cent, respectively, from 0.5 and 2.6 per cent at the end of 2010.

Following the downward trend of the last four years, the outstanding of Saving Certificates dropped by EUR 4,086 million in 2011. This fall was a result of negative net subscriptions (the difference between new subscriptions and redemptions, including accrued interest), which amounted to EUR 4,381 million. Once again, this led to an increase in the average term of Saving Certificates subscribed more

than 5 years ago. The increase in the stock of Treasury Certificates (EUR 623 million) was not enough to offset the decline in the outstanding of Saving Certificates. As a result, retail debt instruments had a negative contribution of EUR 3,464 million to the debt outstanding.

Table 17 – Stock of Saving Certificates
(unit: EUR million)

Year	Stock changes	Net subscriptions	Accrued interest
1997	686	24	662
1998	139	-420	558
1999	486	37	449
2000	1,177	626	551
2001	1,071	403	668
2002	793	215	578
2003	318	-182	500
2004	49	-411	460
2005	343	-130	473
2006	1,003	446	557
2007	801	128	673
2008	-852	-1,534	682
2009	-327	-784	457
2010	-1,400	-1,716	316
2011	-4,086	-4,381	294

CURRENT DEBT COSTS

On a public account basis, the current costs of the direct State's debt with interest amounted to EUR 5,733 million in 2011, while other costs totalled EUR 263 million, EUR 236 million of which are associated with EFAP[6].

Table 18 – Current costs of the direct State's debt
(unit: EUR million)

	2004	2005	2006	2007	2008	2009	2010	2011
PUBLIC ACCOUNT BASIS								
Interest	3,722	3,937	4,366	4,704	4,855	4,973	4,943	5,773
of which: EFAP	0	0	0	0	0	0	0	113
Other costs (*)	18	30	31	24	30	32	26	263
of which: EFAP	0	0	0	0	0	0	0	236
Total costs	**3,740**	**3,967**	**4,397**	**4,728**	**4,885**	**5,005**	**4,970**	**6,036**
NATIONAL ACCOUNT BASIS (**)								
Interest (under the EDP)	***3,826***	***4,054***	***4,365***	***4,691***	***4,867***	***4,778***	***4,948***	***6,405***

(*) Other costs include costs associated to the placement of debt in the market (issuance, distribution, redemption and custody of securities), as well as IGCP's management fee and other expenses related to the rating of the Republic's credit risk.
(**) Unlike Public Accounts, in which flows are recorded on a cash basis, in National Accounts flows are registered on an accrual basis.

On a National Account basis, interest amounted to EUR 6,405 million in 2011, having risen by EUR 1,457 million in comparison to the previous year, as a result of the price effect and the increase in the debt stock.

[6] Note that in the item Intermediate Consumption under National Accounts, the amount concerning Other Charges associated with EFAP loans was only EUR 171 million. This was due to the fact that part of it (EUR 64 million) was reclassified as interest and therefore accrued over the term of the loan.

Table 19 – Interest changes
(unit: EUR million)

Year (1)	Average debt stock (2)	Interest (national accounting) (3)	Implicit interest rate (4)	Interest change (5)	Contributions to interest changes: Stock effect (6)	Price effect (7)	Cross effect (8)
2000	64,566	3,635	5.6%				
2001	69,313	3,771	5.4%	136	267	-122	-9
2002	75,962	3,875	5.1%	104	362	-235	-23
2003	81,426	3,797	4.7%	-79	279	-333	-24
2004	87,058	3,826	4.4%	30	263	-218	-15
2005	96,249	4,054	4.2%	228	404	-159	-17
2006	105,158	4,365	4.2%	311	375	-59	-5
2007	110,681	4,691	4.2%	326	229	92	5
2008	115,633	4,867	4.2%	176	210	-32	-1
2009	125,605	4,778	3.8%	-88	420	-468	-40
2010	142,261	4,948	3.5%	170	634	-410	-54
2011	163,333	6,405	3.9%	1,457	733	631	93

Notes:

(2) = S_t - average stock at the end of t and t-1

(4) = $i_t = (3)_t / (2)_t$

(5) = $\Delta(S_t.i_t) = i_{t-1}.\Delta S_t + S_{t-1}.\Delta i_t + \Delta S_t.\Delta i_t$

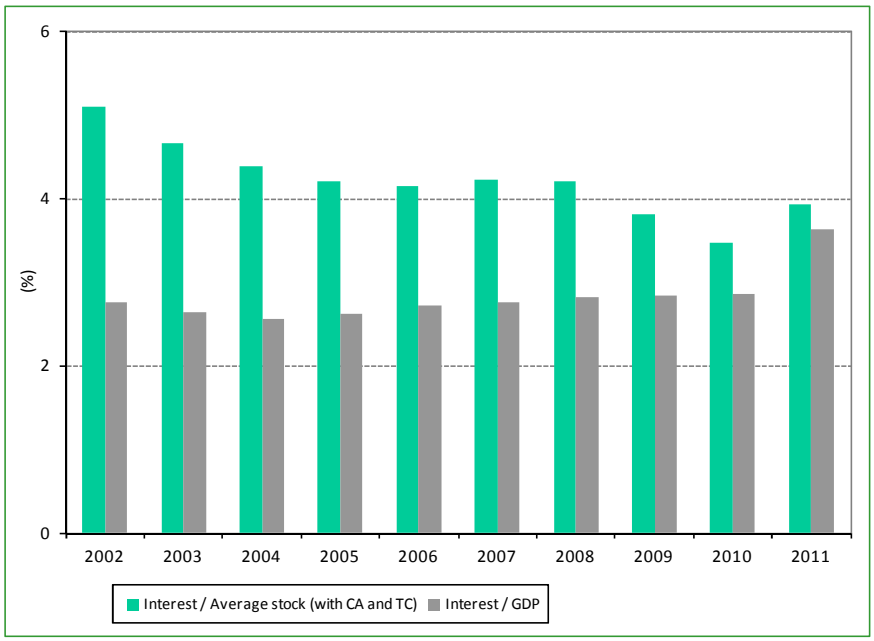
(6) = $i_{t-1}.\Delta S_t$

(7) = $S_{t-1}.\Delta i_t$

(8) = $\Delta S_t.\Delta i_t$

Accordingly, the implicit interest rate (calculated as the ratio between the year's interest, on a public account basis, and the average debt stock) rose from 3.5 to 3.9 per cent at the end of 2011, while the interest-to-GDP ratio increased by 0.8 percentage points, from 2.9 to 3.6 per cent in 2011.

Graph 18 – Changes in the interest of the direct State's debt
(National Accounts Basis)



RISK MANAGEMENT

CHARACTERISATION OF THE DEBT PORTFOLIO AND COST INDICATORS

On 31 December 2011, the market value of the total debt portfolio[7] was EUR 138,330 million, reflecting a -18.1 per cent discount in relation to its nominal value. The portfolio's average coupon rose to 4.07 per cent in 2011. The average residual term increased to 6.34 years.

Table 20 – Debt portfolio at year-end (after swaps)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Outstanding (EUR Million)	62,584	65,823	72,023	79,554	83,611	90,821	101,810	108,609	112,852	117,169	131,892	149,837	165,580
Average coupon	5.55%	5.82%	5.31%	5.14%	4.50%	4.43%	4.09%	4.28%	4.35%	4.47%	3.51%	3.66%	4.07%
Average yield	4.54%	4.96%	4.69%	3.68%	3.18%	2.73%	2.96%	3.93%	4.16%	3.83%	2.93%	4.81%	7.80%
Average residual term (years)	4.17	4.61	4.57	4.55	4.31	3.66	4.89	5.84	6.03	6.26	6.10	5.80	6.34
Modified duration	2.87	2.96	2.98	3.19	2.92	2.98	3.41	2.91	2.71	3.80	3.52	3.80	4.38
Market value (EUR Million)	64,774	69,592	76,444	86,159	89,638	97,901	108,997	112,585	116,071	123,537	138,051	143,505	138,330
Premium (incl. accrued interest)	3.5%	5.7%	6.1%	8.3%	7.2%	7.8%	7.1%	3.6%	2.9%	5.4%	4.7%	-4.2%	-18.1%

Marked-to-market cost

The provisional benchmark model was maintained in 2011. Under this model, active debt management operations carried out by IGCP are included in a separate portfolio whose mark-to-market assessment is used to measure the performance of IGCP's active management.

In 2011, the marked-to-market cost[8] of the Adjusted Debt Portfolio[9] was -11.68 per cent. A cost of-11.89 per cent was calculated for the benchmark portfolio in the same period, resulting in an unfavourable cost differential of 20.7 basis points.

Given the difficulty in trading new financial derivatives as a result of the deterioration of the Republic's credit rating, the assessment of IGCP's performance, based exclusively on active debt management operations, is currently of little significance.

In cumulative terms, since 1999 the total annual cost of the real portfolio was 2.195 per cent, 0.4 basis points higher than that of the benchmark.

Table 21 – Annual cost of the debt portfolio and of the benchmark

	Internal Rate of Return (annualised)													
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	1999/2011
Portfolio	-1.38%	6.30%	6.19%	8.41%	3.81%	5.93%	3.76%	0.64%	3.03%	7.40%	4.04%	-5.89%	-11.68%	2.195%
Benchmark	-0.97%	6.14%	6.23%	8.44%	3.79%	5.95%	3.59%	0.64%	3.03%	7.02%	4.62%	-6.07%	-11.89%	2.190%
Difference (in b.p.)	-41.0	16.0	-3.6	-3.5	2.4	-2.0	16.9	0.0	-0.8	37.7	-57.8	17.9	20.7	0.4

[7] As from 2003, the market value of the OT portfolio has been based on secondary market prices. This methodology was subsequently extended to the BT portfolio. Prior to this, the market value of debt instruments was obtained by discounting cash-flows with benchmark market rates so that credit spreads versus these rates had to be estimated. Currently, all instruments with a liquid secondary market (OT and BT quoted on MEDIP) are evaluated according to prices quoted in this market. For non-liquid instruments, price estimates are calculated by interpolating the yields of liquid instruments.

[8] The marked-to-market cost in 2011 was once again negative because the (negative) effect of the decline in market value outweighed the (positive) interest effect.

[9] The Adjusted Debt Portfolio refers to all the instruments that make up the direct State's debt portfolio, including financial derivatives, with the exception of promissory notes, retail debt, and CEDIC and CEDIM.

RISK INDICATORS

The Guidelines for the Management of Government Debt (Guidelines) identify the risk indicators considered most relevant for the debt portfolio and set limits to its exposure. The Guidelines set maximum limits to the interest rate risk (refixing profile and modified duration), refinancing risk, exchange rate risk and credit risk.

CaR – Cost at Risk[10]

In the portfolio CaR estimate, the portfolio position at the beginning of the year was used as a starting point.

In 2007, IGCP adopted a multifactor model to calculate the CaR – the choice was the Nelson and Siegel (1987) model and the dynamic model proposed by Diebold and Li (2006) was incorporated. The methodology followed in the implementation of the model is described in more detail in the box: MODEL FOR GENERATING INTEREST RATE SCENARIOS, from the 2007 annual report.

Using the State Budget for 2012 to project the annual borrowing needs, the benchmark financing strategy[11], constant financing spreads and the various scenarios for the yield curve dynamics simulated with the model described, the estimated CaR[12] resulting from simulating the portfolio and risk-free interest rate (swap) dynamics for 2012 is as follows:

Table 22 – Portfolio CaR for 2012
(for a confidence interval of 95 per cent)

EUR million	
National Accounts	**2012**
Expected cost	7,435
Absolute CaR (C.I. 95%)	7,600
Relative CaR (C.I. 95%)	165
Relative CaR / Expected cost	2.2%
Relativa CaR / GDP	0.10%

According to the estimated absolute CaR, the expected value of the portfolio costs for 2012 is EUR 7,435 million, with a mere 5 per cent probability of this figure exceeding EUR 7,600 million. The relative CaR for the same significance level is EUR 165 million.

In relative terms and in comparison with GDP, the probability of the deficit-to-GDP ratio increasing by more than 0.10 percentage points in 2012 as a result of changes in risk-free interest rates is lower than 5 per cent.

[10] The CaR (Cost at Risk) is a budgetary risk measure whose follow-up is foreseen in the Guidelines. In 2002, IGCP developed a model to estimate this indicator whose theoretical framework and characteristics were presented in the 2002 Government Debt Management Report. CaR is a statistical estimator of the cash-flow cost of debt aimed at measuring the maximum variation of this cost in a given time frame. This indicator may be presented in two forms: the absolute CaR represents the maximum value of the cash-flow cost for a given probability; the relative CaR reflects the maximum deviation of that cost in relation to its expected value.

[11] Although the benchmark is suspended, the reference strategy which was previously approved continues to be considered as the best reference for computing CaR.

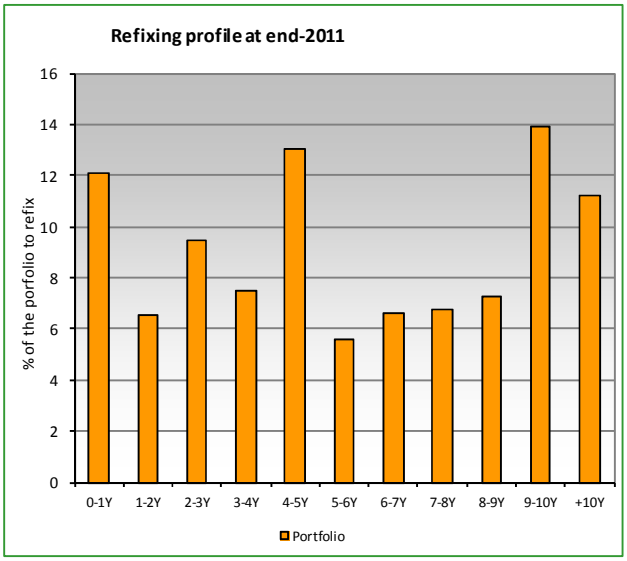
[12] Calculated on a national account basis.

Refinancing risk

In addition to market variables (tradability, liquidity, maintaining a benchmark yield curve, among others), the management of the debt portfolio takes into account the refinancing profile of the debt, so as to avoid an excessive concentration of redemptions that may lead to higher financing costs in the future.

The absolute limits set on the percentage of the portfolio maturing in a 12-month, 24-month and 36-month period are 25 per cent, 40 per cent and 50 per cent, respectively. At the end of 2011, the portfolio had the following refinancing profile:

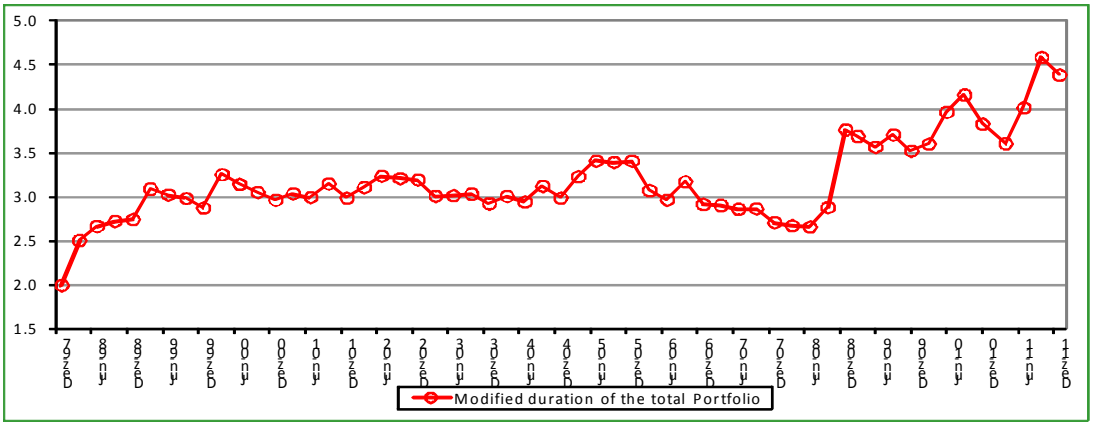
Graph 19 – Refinancing profile of the debt portfolio



Interest rate risk

At the end of 2011, the modified duration[13] of the total debt portfolio and the adjusted portfolio was 4.38 and 4.74, respectively. Throughout 2011, the duration of the adjusted portfolio was always higher than the lower limit (4.0).

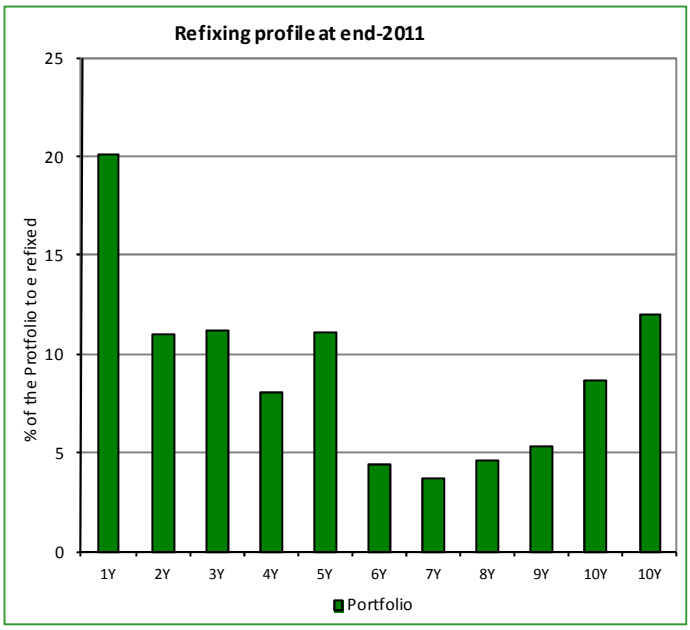
Graph 20 – Modified duration of the total portfolio



[13] The modified duration measures the elasticity of the portfolio's market value to changes in market yields.

At the end of 2011, the debt portfolio had the following refixing profile (i.e. percentage of the nominal value of the adjusted portfolio to be refixed or maturing, by term):

Graph 21 – Refixing profile of the portfolio



Exchange rate risk

At the end of 2011, the net *exchange* rate exposure of the debt portfolio after swaps was 2.45 per cent as a result of the disbursements of the IMF's Extended Fund Facility which is denominated in special drawing rights (SDR), corresponding to a basket of EUR, USD, GBP and JPY. Throughout 2011 the net exchange rate exposure of the debt portfolio after swaps remained below the 10 per cent limit.

IGCP has been using currency swaps to hedge the exchange rate exposure. However, this has only been partially possible, in spite of the new contractual terms of the CSA[14] which reduce the credit risk exposure of derivates. As a result of the deterioration of the Republic's credit rating, counterparties were less inclined to agree on new derivative operations.

The primary exchange rate exposure (excluding hedging operations) was 5.89 per cent of the total portfolio at year-end, far lower than the 20 per cent limit set by the Guidelines.

Credit risk

The assumption of credit risk by the Republic results from operations involving derivatives, repos and money market applications. The Guidelines in force[15] establish the diversification of risk and the limits of exposure attributed to each counterparty according to its credit rating, which are monitored on an ongoing basis.

The credit risk of each counterparty (i.e. of all of its derivative contracts with the Republic of Portugal) is calculated using a methodology which includes two components: its current market value, which

[14] As described in the Box – Risk Management: Bilateral CSA of the Annual Report for 2010.
[15] The Guidelines on Credit Risk in force are detailed in the Box – NEW GUIDELINES FOR MANAGING CREDIT RISK of the Annual Report for 2009.

represents the substitution value of each transaction plus an add-on, designed to estimate the potential change of that value in the future. The market value of the collateral received or delivered under the CSA should be subtracted from the amount resulting from the sum of these two components.

With the aim of minimising the exposure of the Republic to the credit risk associated to derivatives and simultaneously maximising its capacity to carry out new operations at the lowest possible cost, in January 2011 (once all the legal conditions had been met for the delivery of collateral by IGCP) IGCP began negotiating with derivative counterparties to sign bilateral CSA agreements. Following these negotiations, by the end of 2011 IGCP had signed bilateral CSA agreements with 8 counterparties. The list of counterparties for operations involving credit risk currently includes 23 financial institutions with signed ISDA contracts, 7 of which have already signed the unilateral CSA with the Republic.

As shown in the graph below, the credit risk exposure of the derivatives portfolio remained below the overall limit throughout 2011.

Graph 22 – Credit risk – components