

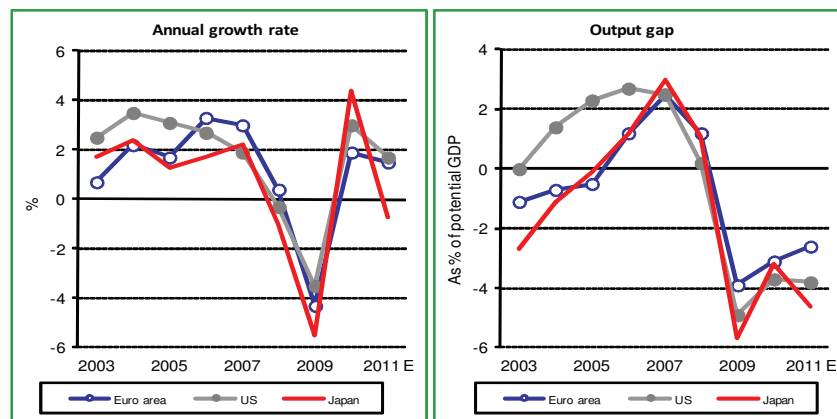
THE ECONOMY AND FINANCIAL MARKETS IN 2011

INTERNATIONAL ENVIRONMENT

The world economy continued to recover in 2011, although according to the IMF¹ 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.

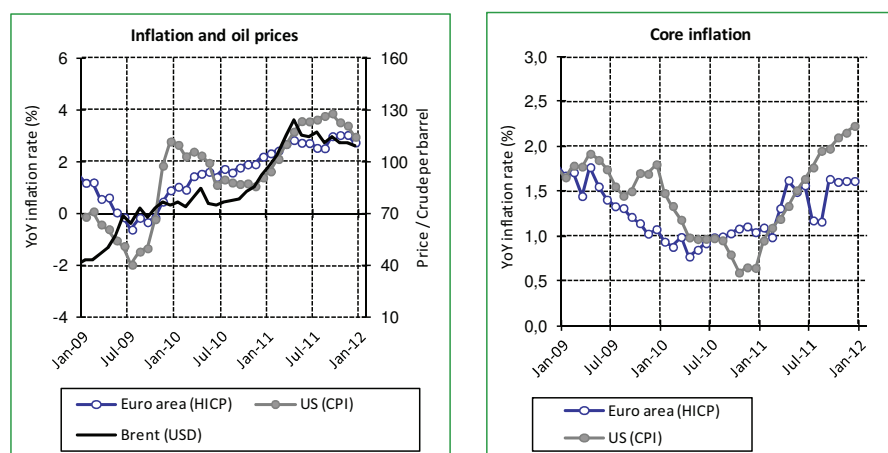
Accordingly, the major international organisations expect the global economic recovery to continue in 2012, albeit at a slower pace than previously expected. In January forecasts, the IMF sees 1.8 per cent growth in the US and 1.7 per cent in Japan while GDP in the euro area is expected to contract by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

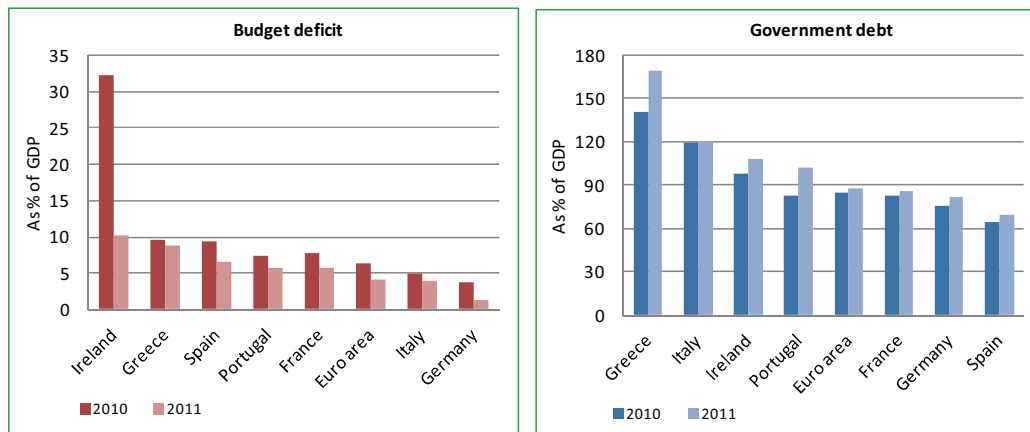


SOURCE: Reuters and Eurostat

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 estimates².

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.

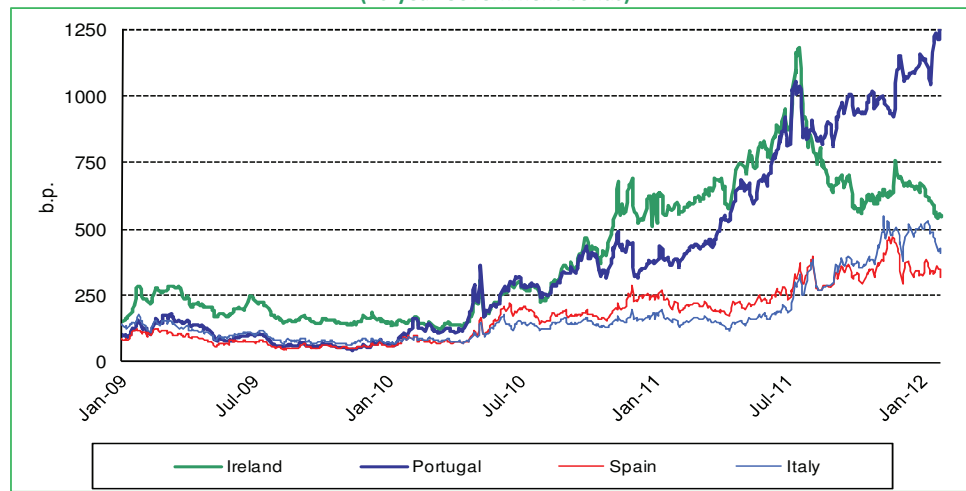
In 2010 and during 2011, the bond market was marked by the sovereign debt crisis in some euro area countries, especially those which ended up requesting financial assistance: Greece, Ireland and Portugal.

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)**

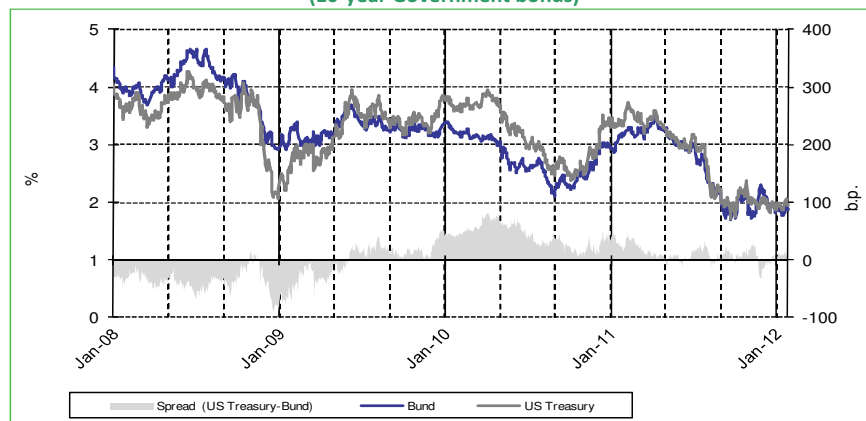


SOURCE: Reuters

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)**



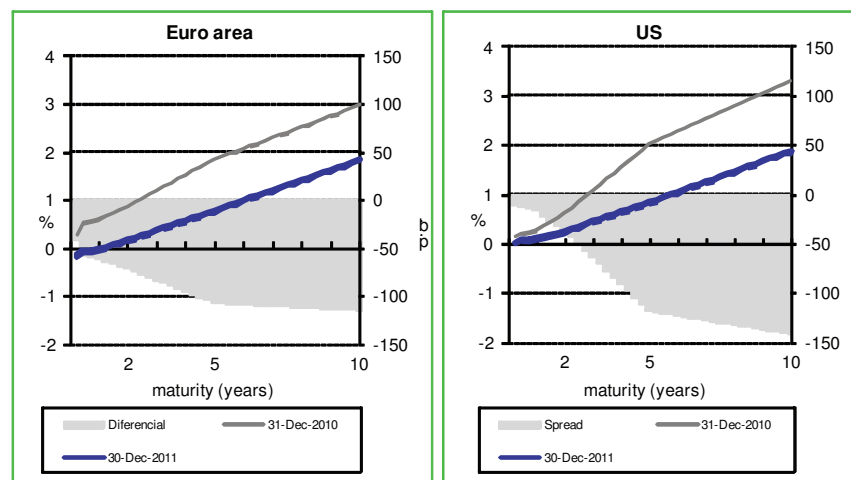
SOURCE: Reuters

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.

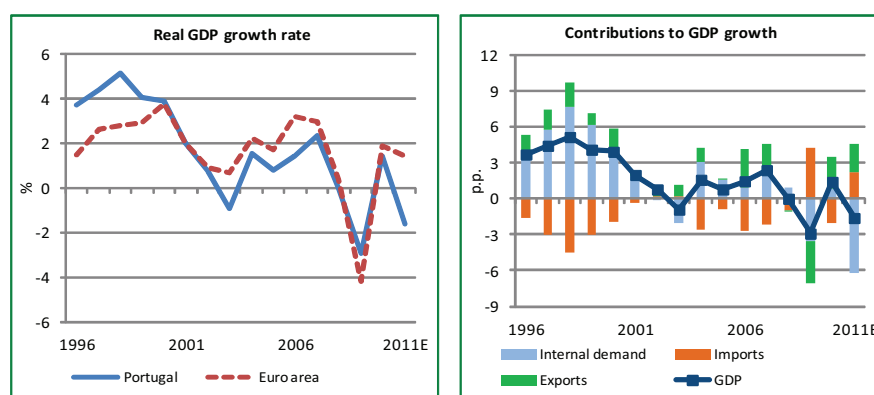
In the foreign exchange market, the euro strengthened against the dollar in the first half of the year. The EUR/USD appreciated from 1.34 at the end of 2010 to a high of 1.48 in May 2011. In the second half of the year, concerns with the sovereign debt crisis and a downward revision of growth led to 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 cent³ 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

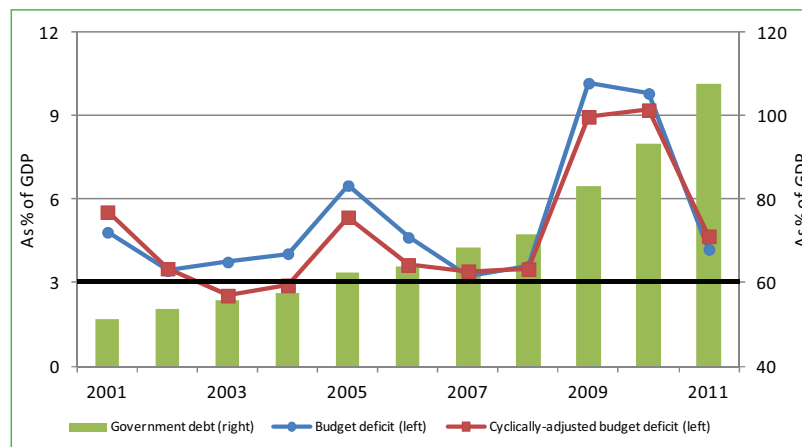
³ Statistics Portugal, Quarterly National Accounts, March 2012.

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.