Notes from the 5th review

- **Deficit targets revised upwards: 5% in 2012, 4.5% in 2013 and 2.5% in 2014**
- **Financing guaranteed for the next 12 months, with no need for additional financial support**
- **External adjustment continues to surprise on the upside**

Budget deficit targets adjusted upwards; structural adjustment on track

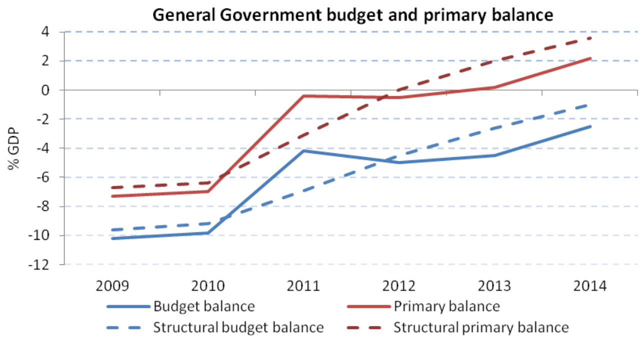
Headline budget deficit targets revised to allow for the operation of automatic stabilizers

The Government and the EU-IMF mission team have agreed to adjust the budget deficit path, mainly to allow for the partial operation of automatic fiscal stabilizers. The target for 2012 was revised from 4.5 to 5% of GDP, while the target for 2013 was raised by 1.5pp of GDP to 4.5%. Deficit is to fall below 3% by 2014, with a 2.5% target.

Crucially, the structural adjustment continues to be significant, sustained by a strong contraction of primary spending. The cyclically adjusted primary balance is expected to be close to balance this year and to increase further to more than 3% of potential GDP by 2014.

Structural primary balance will improve 3.1pp in 2012, on top of 3.7pp already observed since 2009 …

… and adjustment continues to be strong moving forward



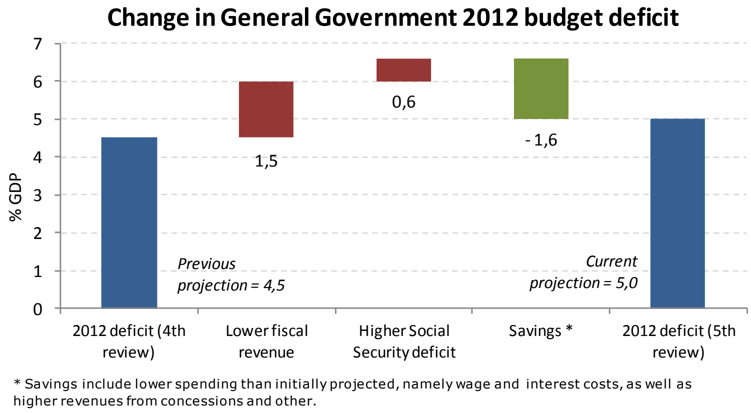
Source: Ministry of Finance (5th review).

In 2012, the higher contraction of domestic demand and wage bill led to both lower fiscal revenue (especially VAT) and lower social security contributions. Moreover, higher unemployment than initially projected increased the level of social transfers above target. The two effects combined contributed to raise the budget deficit around 2pp of GDP this year, with a similar carryover for 2013.

In the 2012 budget, this adjustment will be partly offset by lower spending than initially projected, namely with the wage and interest bills, as well as higher revenues from concessions and a new schedule of EU transfers.

Target for 2012 revised from 4.5% to 5%, mainly due to different composition of GDP growth and higher unemployment …

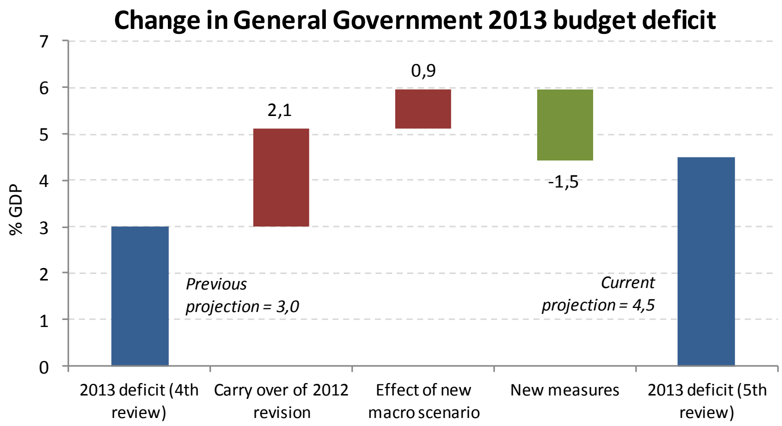
… but spending was kept below target



* Savings include lower spending than initially projected, namely wage and interest costs, as well as higher revenues from concessions and other.

Source: Ministry of Finance.

The adjustment of the target in 2013 by 1.5pp of GDP reduces the need to compensate the carry over effect from 2012 and the less favourable macroeconomic environment. However, additional consolidation measures will need to be taken.



Source: IGCP calculations.

Consolidation measures in 2013 amount to EUR 4.9 billion (of which about half were already planned in the medium-term budget framework)

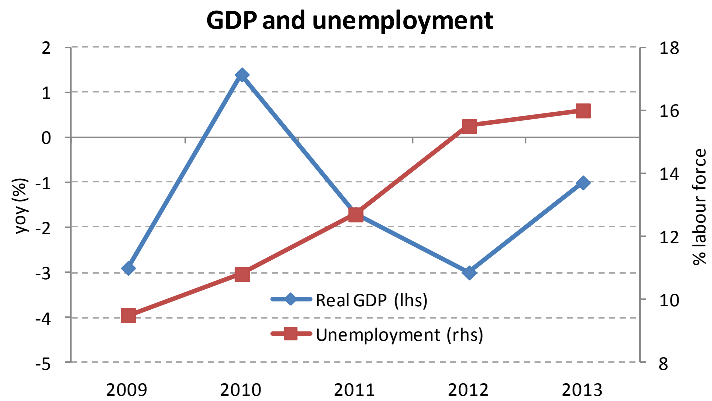
New measures (amounting to about EUR 2.5 billion) include:

- Fiscal devaluation through a reduction of the employers' social security contribution (23.75% to 18%), coupled with an increase of the employees' social security contribution (11% to 18%), with a net positive effect for the budget deficit of about 0.3pp of GDP;
- Streamline Public Administration, by increasing the pace of reduction of public employment and intermediate consumption;
- Reduction of pensions by 5% on average to replicate the civil servants' wage cut that occurred in 2011;

Additionally, structural measures already included in the medium-term budget framework presented in April will continue to be implemented, namely those aiming to reduce SOE's losses, or bring down the costs of PPP.

Macroeconomic scenario: lower GDP in 2013, faster external adjustment

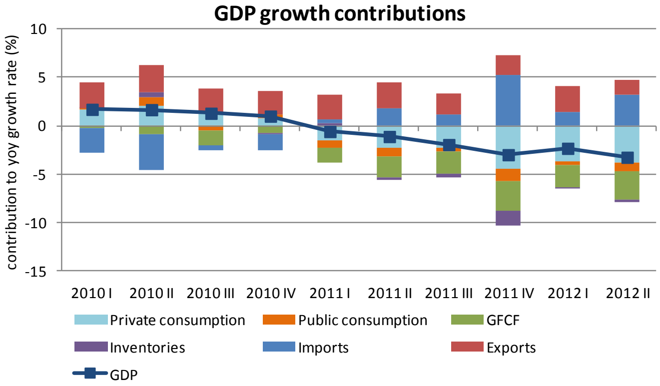
The macroeconomic scenario for 2012 remains broadly in line with previous projections, while the forecast of real GDP growth in 2013 was revised from 0.2% to -1%. This reflects the worse external environment, as well as the expected short-term impact on domestic demand of the additional consolidation measures.



Source: Ministry of Finance.

Fiscal devaluation measure was designed to have a positive impact on firms' competitiveness and employment moving forward

As part of the deleveraging process, domestic demand has already declined significantly in 2011 and first half of 2012. However, this has been partly compensated by the positive performance of net exports.



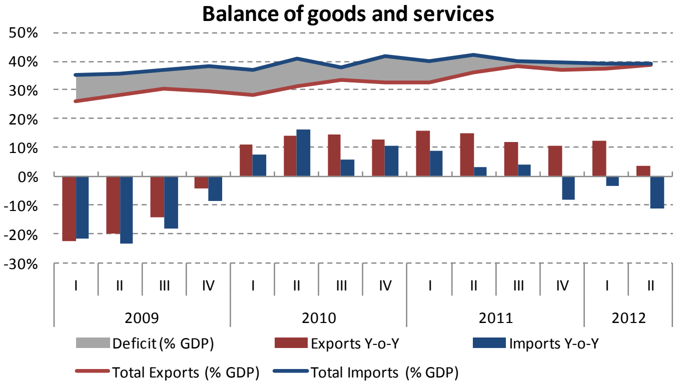
Source: Statistics Portugal.

Exports growth decelerated in the first semester, but should still grow around 4% both in 2012 and 2013 …

In fact, the external adjustment has continued to surprise on the upside. Exports of goods have decelerated somewhat in the first semester, but still less than what would be expected given the external environment, which reflects significant gains of market share. The observed reduction of nominal labor costs, further enhanced with the above-mentioned fiscal devaluation measure, should help sustain this trend.

Moreover, imports are contracting at a strong pace, so that the goods and services account was already close to balance in Q2 (-0.2% of GDP) and it is expected to improve further to 2.3% of GDP in 2013, almost 12pp above the trough observed in 2008 (-9.5%).

… goods and services account is turning positive this year



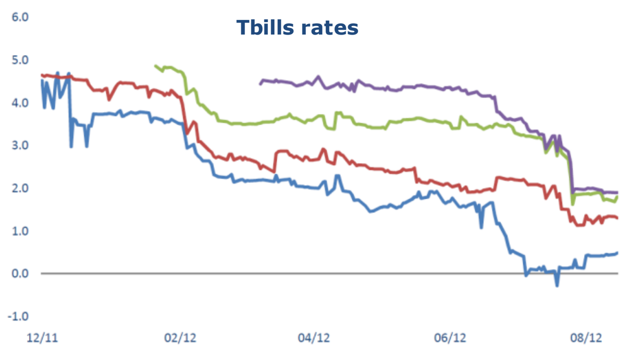
Source: Banco de Portugal.

Financing plan: no additional EU-IMF loans required

Financing conditions favourable to return to MLT market until September 2013, in line with Programme projections

The financing plan for 2013 was discussed and the EU-IMF mission team concluded that the financing sources available are sufficient to match the foreseen borrowing requirements.

Moreover, the rescheduling of the deficit targets does not require additional EU-IMF financial support, given the current cash position and the available set of financing sources.



Source: Bloomberg.

Source: Bloomberg.

Official statements on the 5th review mission to Portugal:

- **Vítor Gaspar (MF-PT)** http://www.portugal.gov.pt/pt/os-ministerios/ministerio-das-financas/mantenha-se-atualizado/20120911-mef-paef.aspx
- **EU-IMF mission** http://www.imf.org/external/np/sec/pr/2012/pr12310.htm
- **Olli Rehn (EC)** http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/657

Further information on the Portuguese economy can be obtained from:

- **Ministry of Finance** www.portugal.gov.pt/en/the-ministries/ministry-of-finance
- **Banco de Portugal** www.bportugal.pt
- **Statistics Portugal** www.ine.pt
- **Portugal Economy Probe** www.peprobe.com

Disclaimer:

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

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