Rating Report

Report Date:
13 December 2013

Previous Report:
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Insight beyond the rating.

Republic of Portugal

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Ratings

Issuer	Debt Rated	Rating	Trend
Portugal, Republic of	Long-Term Foreign Currency – Issuer Rating	BBB (low)	Negative
Portugal, Republic of	Long-Term Local Currency – Issuer Rating	BBB (low)	Negative
Portugal, Republic of	Short-Term Foreign Currency – Issuer Rating	R-2 (middle)	Negative
Portugal, Republic of	Short-Term Local Currency – Issuer Rating	R-2 (middle)	Negative

Rating Rationale

DBRS Ratings Limited (DBRS) has confirmed the Republic of Portugal's long-term foreign and local currency issuer rating at BBB (low) with a Negative trend on both ratings. DBRS has also confirmed the short-term foreign and local currency issuer ratings at R-2 (middle) with Negative trend.

The ratings are underpinned by the progress which Portugal has made with respect to fiscal consolidation and in reducing its large external imbalances. In addition, the ratings are supported by the continued political commitment to the Economic and Financial Adjustment Programme (EFAP) and a sound record of reform implementation. The likely continuation of support for the country's adjustment drive by the Euro area creditor countries, beyond the end of the current EFAP next year, also underpins the rating.

The Negative trend reflects the significant uncertainty over Portugal's fiscal outlook, especially regarding the country's ability to reduce its elevated stock of public sector debt over the medium-term. Moreover, the repeated unfavourable rulings by the country's Constitutional Court with respect to some of the adjustment measures raise implementation risks. This is the case for the fiscal consolidation measures announced in the 2014 budget, and which are essential to the country meeting its fiscal deficit target of 4.0% of GDP next year. The trend further reflects the uncertainty associated with Portugal's growth prospects over the coming months.

(Continued on page 2)

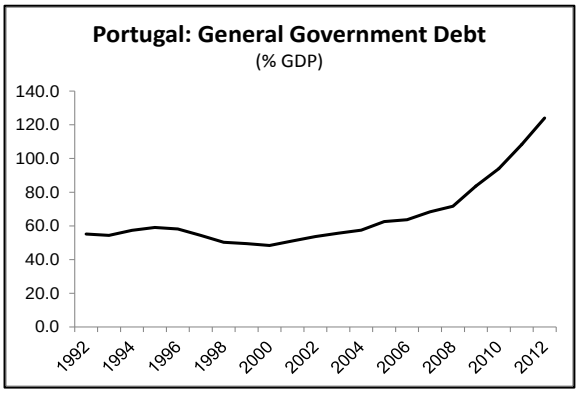
Rating Considerations

Strengths
(1) Benefits of euro area membership
(2) Strong structural reform drive
(3) Moderate fiscal impact of age-related expenditure

Challenges
(1) High and rising public debt
(2) Large deficit
(3) Elevated private sector indebtedness
(4) Uncertain medium-term growth outlook

Summary Statistics

For the year ended December 31	2011	2012	2013F	2014F
Nominal GDP (euro billions)	171.0	165.1	165.3	168.2
GDP per capita (euro thousands)	15,102	14,680	14,408	14,505
Real GDP (% change yoy)	-1.3	-3.2	-1.8	0.8
Unemployment rate (%)	12.9	15.9	17.4	17.7
Inflation (%)	3.6	2.8	0.6	1.0
Current account balance (% GDP)	-7.0	-1.9	1.0	1.0
External debt (% GDP)	231.3	235.4	227.4	218.1
General gov't balance (% GDP)	-4.3	-6.5	-5.9	-4.0
Primary balance (% GDP)	-0.3	-2.1	-1.6	0.3
Gross public debt (% GDP)	108.4	124.0	127.9	126.6
Human Development Index	0.817	0.816	n.a.	n.a.



Rating Rationale (Continued from page 1)

The ratings could therefore come under pressure if, in the absence of a new financial support program, it becomes likely that the sovereign will not be able to attain a sustainable mix of public and private sector financing to meet its borrowing needs once Portugal exits the current EFAP. In addition, deficits above the targets over the coming years as a result of fiscal slippage could also put downward pressure on the ratings. Fiscal slippage could result from implementation failure, lower than anticipated growth, or the materialisation of contingent liabilities from the state-owned enterprises (SOEs), the public-private partnerships (PPPs), or the banking sector. However, DBRS acknowledges that the risks emanating from contingent liabilities in Portugal appear to have subsided a little as a result of the introduction of new expenditure controls and the savings achieved on some of the PPP contracts.

Conversely, the trend could be changed to Stable from Negative if Portugal makes significant headway in reducing its public debt and if the country's medium-term growth prospects were to improve. Such an improvement could come from a mix of a better than expected external environment, providing a sustained impetus to the country's export sector, and from structural reforms that lead to long-lasting increases in employment and productivity. An improvement in the financing environment faced by households and firms would also support the recovery.

Since it entered the adjustment programme in May 2011, Portugal has made considerable progress in reducing its fiscal deficit, lowering it from 9.9% of GDP in 2010 to a target of 5.5% of GDP by end 2013. In structural terms, the deficit has improved from 9.0% of GDP in 2010 to an estimated 3.6% of GDP by the end of 2013. The primary structural balance is expected to reach a 0.5% of GDP surplus by the end of 2013. Moreover, the nascent signs of an economic recovery and the apparent peaking of the unemployment rate at a lower and earlier-than-previously-anticipated level could prove supportive of the fiscal adjustment going forwards.

In addition, Portugal has experienced some success in rebalancing the economy towards the tradable sector, which helped by a marked contraction in imports, has underpinned the reduction in the country's current account deficit to an estimated surplus of 0.5% of GDP in 2013, from a deficit of 1.9% of GDP in 2012. The current account balance is expected to improve further and reach a surplus of 1.1% of GDP by 2015 and 2.8% of GDP by 2018 driven by sustained growth in exports of goods and services.

The ratings are also supported by the implementation of structural reforms aimed at improving competitiveness, and the enactment of laws to better monitor and control government spending. The ratings are further supported by the continued political support for the adjustment programme and by a relatively benign outlook for the long-term sustainability of age-related spending.

These factors, which underpin Portugal's sound track record of compliance with most aspects of the adjustment programme, are likely to help the country secure further support from the various euro-area financial assistance mechanisms, were it to find market access difficult once the assistance programme expires in June 2014. However, marked challenges remain. In particular, the combination of an elevated public debt ratio and uncertain growth prospects continues to severely constrain Portugal's credit worthiness.

Foreign Versus Local Currency Ratings

The Portuguese government issues predominantly in euros, with non-euro-denominated loans worth EUR0.3billion expiring in 2015, EUR1.8billion expiring in 2016, and EUR2.6 and EUR2.7billion worth of payments due in 2016 and 2017. The share of government debt held by the non IMF-EU non-resident sector was 35% of the total in the first quarter of 2013. DBRS maintains its foreign and local currency ratings at the same level because the Portuguese government's ability to refinance the bonds in FC is commensurate with its ability to refinance Euro-denominated bonds.

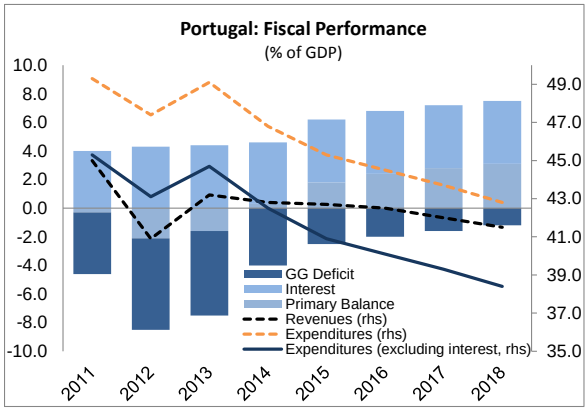
Fiscal Management and Policy

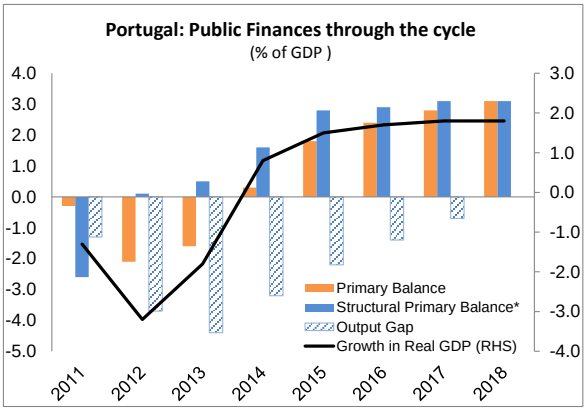
Portugal's fiscal track record is characterized by sizeable deficits but also by considerable recent progress in addressing them. In order to reverse the trends that were leading to unsustainable public finances, in 2011 the country embarked on a strategy of structural fiscal adjustment under the auspices of the ECB, European Commission (EC) and IMF-backed Economic and Financial Assistance Programme (EFAP).

In DBRS's view, and as was the case with the 2013 Budget, the size and composition of the consolidation effort in 2014 raises some implementation risks associated with potential negative rulings on the measures by the country's Constitutional Court. However, DBRS highlights that the government has attempted to mitigate the risks associated with potentially unfavourable court rulings by better balancing the need to address the long-term sustainability of the social security system with the need to retain a degree of public-private sector and intergenerational equity. The risks have also been mitigated by the government justifying the legislation underpinning the expenditure reforms on the grounds of ensuring compliance with the fiscal sustainability rules enshrined in the European Fiscal Compact, which now ranks higher than ordinary national regulation. In addition, the government is relying more extensively on general laws - rather than one-year budget laws - to allow for the possibility of prior constitutional review of the laws, thus facilitating early reaction on the part of the government in case the proposed reforms raise constitutional issues.

Moreover, weighing somewhat positively on Portugal's medium to long-term fiscal outlook are the prospects for the country's long-term fiscal sustainability, which compared favourably with those for other advanced economies even before the recent consolidation packages were taken into account. In particular, the increase in the retirement age to 66 years (enacted in Budget 2014) and other reductions in the costs of pensions should help to further improve Portugal's long-term fiscal sustainability position.

Portugal's adjustments thus far have been reflected in an improvement in the structural primary balance from a deficit of 6.2% of GDP in 2010, to a surplus of 0.1% of GDP in 2012. By the end of 2013, the surplus is expected to reach 0.5% of GDP. This improvement in the structural primary balance means that nearly 72% of the adjustment expected by 2018 will have been achieved between 2011and 2013.





Sources: The Economic Adjustment Programme for Portugal, EC, IMF, Haver Analytics, DBRS.

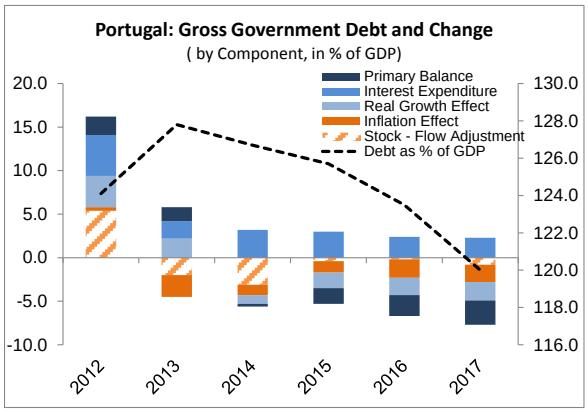
The fiscal adjustment achieved between 2010 and 2013 has been balanced between expenditure (52%) and revenue (48%). Within the expenditure cuts, 34% reflected a reduction in the compensation of public sector employees, 33% from a reduction in capital expenditure, and 17% resulted from other cuts in current primary expenditure. These were only somewhat offset by an increase of 31% in spending on social benefits. As a result of the consolidation measures, primary expenditure has been cut by 13% from EUR84.1billion (48.7% of GDP) in 2010, to an estimated EUR74billion (44.8% of GDP) in 2013. These are expected to decrease further to EUR71.4billion (42.4% of GDP) in 2014 driven by a reduction in the wage bill for public sector workers to EUR15.8billion from EUR19.4billion in 2010. Of the 48% of the consolidation which was delivered through increases in revenues, 31% reflected an increase in taxes on income and wealth and 7% derived from an increase in taxes on production and imports. As a result, total revenues have risen to an estimated 43.3% of GDP from 41.6% of GDP in 2010.

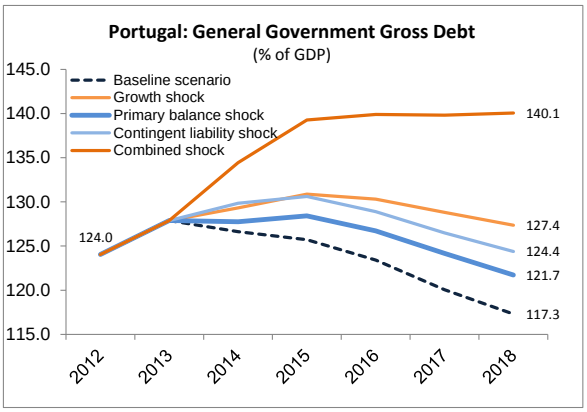
Meeting the deficit target for end-2013, however, relies on the effects of the measures adopted in the 2013 Supplementary Budget and on the on-going improvement in tax revenues driven by the slowdown in the rate of contraction in private consumption. The measures introduced with the Supplementary 2013 Budget - and which constituted alternative measures to accommodate the ruling of the Constitutional Court on some of the initiatives included in Budget 2013 – are expected to bring about reductions in expenditure of EUR4.7billion, with EUR1.4billion due to take effect in 2013 and EUR3.3billion in 2014. The 2013H1 budget deficit execution suggests that, excluding the 0.4% of GDP associated with the intervention in the country's bank BANIF, the country is on schedule to meet the target of a fiscal deficit equivalent to 5.5% of GDP in 2013.

The 2014 budget includes further consolidation measures amounting to 2.3% of GDP (EUR3.9billion), which are aimed at helping Portugal meet the 4.0% of GDP target for the deficit and to secure an improvement in the structural primary balance surplus from 0.5% of GDP in 2013 to 1.6% in 2014. The measures included are predominantly expenditure-based in order to offset increases in the tax burden in 2013. Including the 2014 budget measures, 55% of the EUR26.5billion in permanent consolidation measures adopted to-date will be on the expenditure side.

Debt and Liquidity

Portugal's public debt has been on a rising trajectory since the early 2000s and is currently expected to reach just under 128% of GDP by end 2013. The country's debt is expected to decline gradually beginning in 2014. It is expected to reach 117% by 2018, driven by an improvement in the primary balance from -1.6% of GDP in 2013 to 3.1% of GDP by 2018. Growth is expected to contribute to the reduction in the debt stock with real GDP recovering from a 1.8% contraction in 2013 to an average growth of 1.7% over the 2015-2018 period. Inflation, if it materializes, will also help to reduce the country's debt as it picks up from an estimated 1.0% in 2014-2015 to 1.5% on average between 2015 and 2018, according to the IMF, while the GDP deflator is expected to average 1.8% per annum.





Note: Under the primary balance (PB) shock scenario, the PB averages 1.6% of GDP over the 2014-2018 period rather than 2.6% as under the baseline. The contingent liabilities shock reflects a materialization of contingent liabilities worth 5% of GDP with 3.6% and 1.2% of GDP felt in 2014 and 2015, respectively. The combined shock reflects the combination of the growth shock, the PB shock and the contingent liabilities shock. Sources: The Economic Adjustment Programme for Portugal, EC, IMF, IGCP, Haver Analytics, DBRS.

However, risks to the debt trajectory remain, especially related with the macroeconomic assumptions underpinning the envisaged reduction in debt. Moreover, a reduction in government debt to 117% of GDP by 2018 may not be sufficient to cement market confidence in Portugal's ability to grow at sufficiently high rates to make further inroads into debt reduction post 2018. This view is supported by the latest IMF and EC assessment which concludes that Portugal's sizeable debt burden (some 40ppts higher than the benchmark for advanced economies of 85% of GDP) could hinder the country's growth prospects.

Moreover, weaker than anticipated growth could pose risks to debt reduction in Portugal. DBRS modelled a scenario for the debt stock where the economy grows more slowly than anticipated over the 2014-2015 period, and experiences a less pronounced pick-up in trend growth than assumed, under the baseline scenario. Under the baseline scenario, growth in the medium-term is expected to average 1.8%, driven by the beneficial effects of the structural reforms undertaken as part of the adjustment programme and the measures aimed at

rebalancing the economy away from domestic consumption and into the tradable sector. By contrast, under DBRS's growth shock scenario, the country's debt peaks two years later (in 2015) than under the baseline and at approximately 131% of GDP, driven by an average growth rate of only 0.5% over the 2014-2018 period.

DBRS also considered the potential for fiscal slippage due to weaker growth or due to the failure to implement the fiscal consolidation measures required to improve the primary balance to 3.1% of GDP by 2018, to impact negatively on the country's debt dynamics. Under such a scenario, the debt to GDP still peaks in 2013 but it falls more modestly thereafter to reach just under 122% of GDP by 2018. In addition, a realization of contingent liabilities amounting to 5% of GDP was also considered. Under such a scenario, the 2014 debt ratio would reach nearly 130% in 2015, but it would subsequently ease to 125% of GDP by 2018. It would, however take a combination of a primary balance and a contingent liabilities shock, to drive the debt to GDP markedly away from the currently projected path.

Developments which could drive a primary balance or contingent liabilities shock include increases in general government arrears to suppliers, transfers to the country's State-Owned Enterprises (SOEs) or a further materialization of liabilities from the country's Public Private Partnerships (PPPs) or the banking sector. However, these risks appear to be subsiding. For example, whilst the stock of government arrears continued to be sizeable at 1.6% of GDP (or EUR2.6billion) by end 2013Q3, it fell from 1.8% of GDP in 2013Q2, likely reflecting the implementation of the new expenditure commitment controls system by most budgetary entities. SOEs however, continue to present downside risks to the country's fiscal position and debt dynamics with figures for 2013H2 showing aggregate losses of EUR0.7billion emanating from the SOEs inside the government. These represent a marked deterioration on 2012H1, when profits from Parpublica totalled EUR0.46billion following the privatization of the electricity generator, EDP, and the energy distribution company, REN. In addition, there are downside risks associated the elevated levels of debt accumulated by SOEs inside and outside the perimeter of the general government.

A further source of potential liabilities that could push the country's deficit and debt higher relates to the Portuguese National Guarantee System (NGS), which broadened its coverage to include several guaranteed credit lines to Small and Medium Enterprises (SMEs) during the global financial crisis. This extension of credit lines to SMEs has resulted in approximately 1.7% of GDP in outstanding credit guaranteed, which makes it one of the largest mutual guarantee systems in Europe.

By contrast, weighing favourably on the country's financing needs is the successes of the privatization programme to date, with receipts reaching 3.0% of GDP by end 2013 and expected to yield a further 0.1% of GDP in 2014, which is above programme expectations. Moreover, the successful completion of the combined 8th and 9th EC and IMF reviews, paved the way for the disbursement of EUR 5.6billion. Portugal has now received 90% of the total EUR79billion financing under the programme. Its debt owed to the official sector is projected at 50% by end-2013, and expected to be at 60% by end-2014.

A further mitigant of Portugal's elevated stock of public sector debt and associated financing pressures is the result of the Eurogroup's decision to adjust the maturities on EFSF lending to Portugal (EUR24.8billion to date) by seven years. This maturity extension helped smooth the government's debt redemption profile by increasing the average maturity of the country's public debt from 7.0 to 7.8 years (with maturities on average of 4.8 years for the privately-held debt and 14 years for obligations held by the official sector). Moreover, the government's swap, in December 2013, of EUR6.6billion worth of debt maturing in 2014-15, for debt maturing in 2017-2018 also reduces to some extent the financing needs faced by the country immediately after the end of the EFAP. Finally, the Portuguese Treasury accumulated a cash buffer of EUR15.6billion by end-September (including deposits in the Banking Sector Stability Fund), which together with the remaining official loan disbursements and assuming broad roll-over of Treasury bills, will – under current assumptions – be sufficient to cover the government's financing needs until at least the middle of 2014.

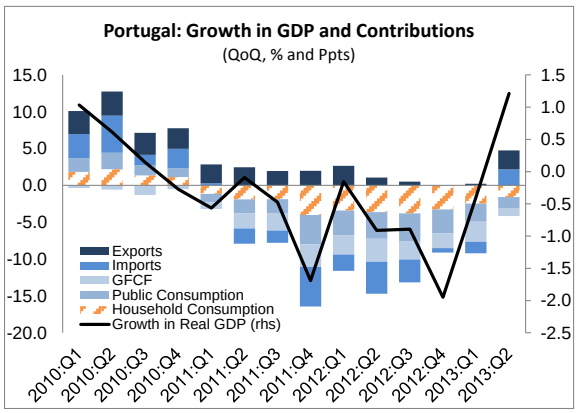
However, post-adjustment programme, Portugal expects to fund its borrowing needs - approximately 20% of GDP per annum - through a mixture of short and medium and long-term (MLT) issuance, with foreign investors expected to absorb 60% of longer-term issuance by 2018. DBRS believes that Portugal's ability to tap the markets for longer term funding at yields which the country can afford, is not yet guaranteed. DBRS therefore sees a material likelihood of domestic sources being relied upon to absorb a non-trivial portion of

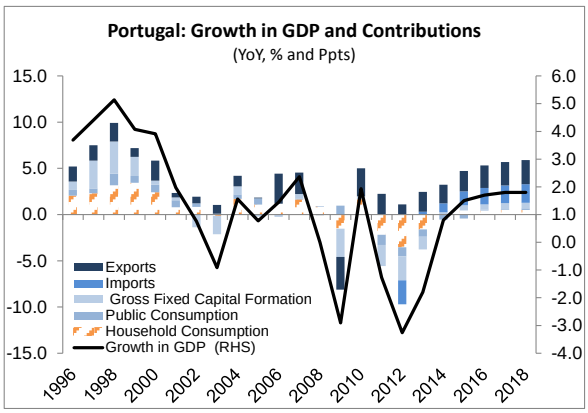
the issuance. Domestic sources likely to increase their holdings of Portuguese government debt include the country's MFIs – with current holdings of 23.7% as a share of total banks assets and 9.1% of GDP, and the Social Security Financial Stabilization Fund which was granted permission to invest up to EUR4billion of its foreign reserves in domestic sovereign debt in 2013 alone, and which has a revised mandate which allows it to use up to 90% of its assets to buy domestic government securities. DBRS further cautions that as Portuguese MFIs and corporates' access to finance at sustainable yields is closely linked to that of the sovereign, the government's efforts to regain market access will prove important for the entire economy. To that effect, DBRS believes that Portugal may seek to negotiate a form of further official support - to shore up the yields - on its new issuances as part of its programme exit strategy.

Economic Structure and Performance

Portugal's GDP per capita, stood at EUR14,680 in 2012. This was 30% below the average for the Euro Area 17, roughly unchanged in relative terms, to the country's position in 2002. However, since the onset of the financial crisis, Portugal's fall in GDP per capita (of only 1.1%) has been attenuated somewhat by the 0.3% fall in population between 2008 and 2012.

The structure of the Portuguese economy has undergone some change in recent years as a result of the recession and the policies adopted under the EFAP. In particular, the share of agriculture, forestry and fishery in total output fell by 40% to 2.6% in 2012 from 3.9% in 1995. Construction experienced the largest drop in output both in the ten years to 2007 and during the recession. By contrast, financial services, real estate and services increased their combined share of total output to about 92% in 2012 from 87% in 1995.





Source: PTINE for outturn, IMF 8th & 9th Review for forecasts, Haver Analytics, DBRS.

After a contraction of 5.5% in GDP over the 2009-2012 period, Portugal's near-term economic outlook improved somewhat in the first half of 2013 with output and employment surprising on the upside, especially in the second quarter, when GDP expanded by 1.1% quarter-on-quarter. Growth in the second quarter was primarily driven by domestic demand, of which 0.3 percentage points was contributed by private consumption and 0.1 percentage points by changes in inventories. Gross fixed capital formation (GFCF) grew by 0.3% in the second quarter. The growth contribution of net exports fell from 1.7 percentage points in the first quarter to 0.7 percentage points in the second as continued strong export growth was offset by fast growing imports partly explained by the aircraft transactions but also by crude oil stocking in light of the relatively low oil prices.

Given that recent high frequency indicators point to some stabilization in activity and confidence, output is expected to remain broadly flat in the second half of the year, contracting somewhere between 1.6% and 1.8% over the full year (a somewhat more benign outcome than the 2.3% contraction previously anticipated by the EC and the IMF). The upward revision for 2013 reflects mainly a less negative contribution from domestic demand and strong growth of exports of goods and services, which however is largely offset by an upward revision of imports. For 2014, GDP is expected to expand by nearly 1.0%.

Since the crisis, investment contracted an average 9.2%, driven by construction and transport which together account for 66% of all investment. Investment is expected to contribute significantly to growth, with expected

average growth of 3.9% per annum between 2015 and 2018. The pick-up in investment over the forecast period (from a contraction of 6.1% on average over the 2007-2013 period) is expected to reflect the reform of corporate income tax (CIT) which aims to simplify the tax structure, reduce compliance and administrative costs and revamp the tax code to make the country more attractive to FDI and to reduce the debt-bias inherent in the Portuguese tax system. In addition, the government is also exploring initiatives to improve financing for SMEs by considering resorting to the combination of national allocations under the European Sustainable Investment Fund, EU programmes dedicated to SMEs and resources from the EIB and the EIF aimed at facilitating financing of economically viable SMEs. Together with micro firms, SMEs make up 99.7% of total enterprises in Portugal.

Notwithstanding the improved near-term outlook, uncertainties remain as the drag of private sector deleveraging and fiscal consolidation on growth could prove stronger than expected, resulting in GDP growth substantially below the 1.5% average expected for the 2014-2018 period. Labour market conditions stabilised in line with economic activity, with unemployment falling back to 15.7% in October, after peaking at 17.6% in February. Total employment increased by 1.6% in 2013Q2 and by 1.1% in 2013Q3, following a cumulative decline of 4.8% in 2012Q4 and 2013Q1. Going forwards, employment is forecast to contract by some 4% in 2013 and by another 0.5% in 2014. By contrast, the unemployment rate has been revised down by 1.0 percentage points in 2013 and ¾ percentage points in 2014 and is now forecast to average at 17.4% in 2013 and 17.7% in 2014, respectively.

DBRS cautions, however, that youth unemployment, while also currently retreating from its April peak of 40.2%, remains at 36.5%. In addition, the unemployment rate would have been higher had the previous falls in employment not been partly offset by a decline in labour market participation. On the plus side, around a ¼ of all new employment contracts were permanent ones. However, the risks appear to be on the upside as the unemployment rate averaged 16.7% in the ten months to October, 0.7 percentage points below the forecast for 2013 as a whole. In DBRS's view, a declining unemployment rate, even if from very high levels, will lend some support to the current government's adjustment programme.

Consumer price inflation dropped to 0.0% in October 2013, significantly below the euro-area rate of 0.7%. The reinstatement of two monthly bonus payments for public-sector workers (equivalent to a 16.7% increase in public sector wages) is, however, expected to have a significant effect on total-economy labour costs and will to impact on the GDP deflator in 2013 which is expected at 1.9% before falling to 0.9% in 2014. Headline inflation is expected to average 1.0% in 2014. DBRS cautions that whilst a low inflation environment relative to trade partners should have a positive effect on Portugal's competitiveness, it will make debt reduction more challenging.

Monetary Policy and Financial Stability

The Portuguese banking sector remains fragile as a result of the long-standing contraction in economic activity and elevated unemployment rate. In particular, MFIs have now endured a long and sustained period of low profitability as a result of weak asset quality, high funding costs, and low levels of new lending. Moreover, the high concentration of low-margin yielding mortgages in the balance sheets of the domestic MFIs also puts pressure on their ability to generate profits. In fact, the country's banking sector recorded only one quarter of positive net profits over the past two years and posted over EUR1billion of losses in 2013H1, of which EUR0.8billion pertained to the results for 2013Q2, highlighting the strain under which the banking sector remains driven to some extent by the recognition of losses associated with Non-Performing Loans (NPLs).

NPLs on lending to NFCs increased from 13.0% at end 2012 to 13.8% in the first half of 2013. However, the increase in NPLs for lending to households appears to be near peaking having increased only modestly from 4.2% at end 2012 to 4.3% in 2013H1. In addition to the gradual deterioration in the quality of assets, banks have experienced a squeeze on net interest income (down by 29% year-on-year) as a result of a combination of persistently low interest rates and falling new lending volumes. However, the pace of decline in lending has somewhat stabilized for some types of lending relative to 2012. For example, bank lending to the non-financial private sector, although markedly below the average growth observed pre-crisis, and still on a resolute downward trend, is now contracting at a slower pace than in 2012 and the rate of decline in lending to households appears to have peaked.

Moreover, and against a backdrop of a slight improvement in liquidity, MFIs appear to have become less restrictive in financing certain sectors of the economy. Recent survey results showed that only 10% of firms active in the services sector or manufacturing industry mentioned bank credit access as a major hurdle for their business development plans. By contrast, 55% of firms in the construction and real estate sector quoted bank credit as a problem. The most affected sectors have been those more dependent on domestic demand and credit to exporting firms has been growing steadily, perhaps reflecting lenders' awareness of the restructuring of the Portuguese economy towards the tradable sector.

The fall in bank lending and the behaviour of household deposits - which, after growing sharply in 2011, have remained relatively stable since 2012 - has underpinned the deleveraging of the Portuguese banking sector in recent years. The loan-to-deposits ratio, which hovered around 160% in 2010 (one of the largest among European countries by that time), fell to 123% by 2013H1. Moreover, Portuguese banks have continued to strengthen their capital provisions through a mixture of issuance and capital injections by the government as well as through some reallocation towards assets with lower risk weights. As a result, banks capital adequacy ratios improved from 8.1% at the end to 2010 to 11.9% by 2013H1. Moreover, the Bank Solvency Support Facility (BSSF) still contains approximately EUR6.4billion which could be used to provide additional capital to banks struggling to meet their capital adequacy requirements. In addition, the improvements in capital and funding structures of the country's banks coupled with improvements in governance within the sector should alleviate the risks. In particular, giving the Bank of Portugal an explicit mandate to design the banks' new Financial Stability Department as a resolution authority should improve transparency.

Nonetheless, DBRS cautions that Portuguese banks continue to rely heavily on ECB funding through LTROs for liquidity provisions and risks to financial stability remain. Going forward, asset quality may deteriorate further as the number of impaired assets continues to rise, although at a slower pace exacerbating the challenges associated with MFIs needs to restore profitability as these impairments turn into losses.

Balance of Payments

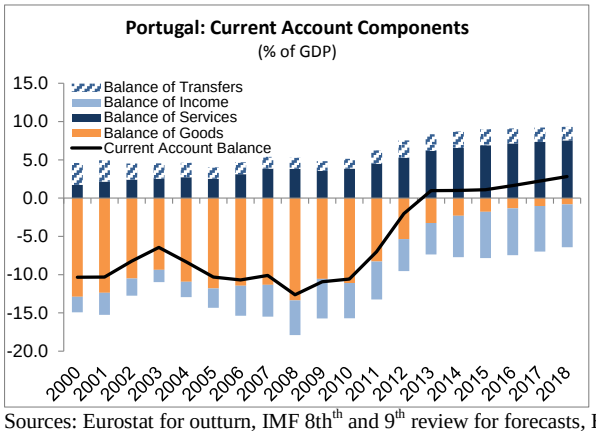
Portugal's external adjustment continued to gather pace in 2013. The balance of the current and capital accounts is expected to improve from 0.3% of GDP in 2012 to 2.4% by end-2013. Moreover, the current account is expected to move into a surplus of 1.0% of GDP by year-end, the highest in more than five decades, before increasing further to 1.8% of GDP in 2014, bringing the cumulative improvement in the country's current account to nearly 14% of GDP since 2009. This improvement resulted to a large extent from the increase in exports of 19.8% between 2010 and 2018 which greatly outpaced the 8.0% increase in world exports.

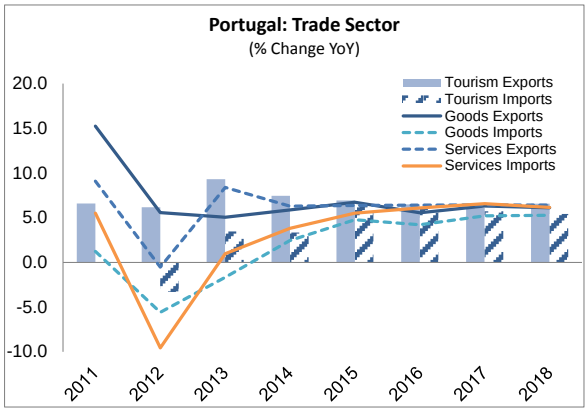
Portugal's export growth in recent years reflects gains in market share both within the country's product markets and among its destinations. However, growth in exports appears to have been limited by its continued focus on slow-growth destinations, while the country's product specialization has also failed to provide much of a stimulus. This suggest that although the share of Portuguese exports going to the euro area has fallen from 63% on average over the 2008-11, to 60% in 2012, Portugal would still benefit from further boosting the share of its exports going to the faster growing non-euro area countries. On the upside, Portugal appears to have increased its exports to Spain (22.4% of total exports in 2012) at a time when Spanish imports were falling, which resulted in a gain in market share in relation to the country's most important single export destination. This bodes well for Portugal's export performance if growth in the Spanish economy regains momentum in the coming years.

The improvement in Portugal's current account hinges on a continuation of the recent improvement in exports offsetting the likely gradual recovery in imports. In 2013, exports continued to grow, particularly strongly towards non-EU countries. The upward trend in exports to date has resulted in an increase in the exports to GDP ratio of seven percentage points between 2010 and 2012 to 39%. The government expects this to increase further to 41% of GDP in 2014.

Portugal's export performance will also be affected by developments in unit labour costs (ULCs) relative to its main competitor countries, which will in turn reflect trends in employment, productivity and wages. ULCs improved by 4.2% between 2010Q1 and 2012Q4 driven mostly by reductions in unit labour costs in the

tradable (i.e. manufacturing) sector, whilst more economy-wide gains in ULCs are yet to materialise. The absence of stronger gains in ULCs reflects subdued improvements in productivity and a reticent slowdown in wages. Thus, whilst the average nominal compensation declined by 3% during 2010-12, in the first half of 2013 it reverted to a level higher than the 2010 peak, due to the reinstatement of the 13th and 14th month salary for publics sector employees which was temporarily suspended during 2011-12.





Sources: Eurostat for outturn, IMF 8th and 9th review for forecasts, Haver Analytics, DBRS.

Political Environment

Last general election: June 5, 2011
Next general election: No later than 2015
Parties in power: Social Democrat Party (PDS)-led coalition with the People's Party (CDS-PP)
Government Structure: Parliamentary democracy
Prime Minister: Pedro Passos Coelho

Portugal last held elections for its 230-seat Parliament on 5 June 2011. The elections resulted in the victory of the centre-right Partido Social Democrata (PSD) led by Mr Pedro Passos Coelho, over the incumbent centre-left Partido Socialista (PS). A centre-right coalition between the PSD and the CDS/PP was subsequently formed resulting in a 132-seat majority government.

Since then, Portugal has undergone a period of marked economic contraction, a pronounced increase in unemployment and has experienced a succession of austerity budgets which have reduced wages and increased taxes. Perhaps not surprisingly, this sustained economic hardship was accompanied in the summer of 2013 by a political crisis which resulted in the resignation of the Finance Minister, Mr Victor Gaspar, and was swiftly followed by the resignation of the leader of the junior coalition partner and Foreign Affairs Minister, Mr Paulo Portas. At a time when market sentiment was also affected by the negative ruling of the Constitutional Court with respect to a key public expenditure reform which limited the government's scope to dismiss public sector employees, the political crisis resulted in an increase in yields on Portuguese government bonds, which offset the gains made earlier in the year.

Political stability was restored when Mr Portas was promoted to the position of Deputy Prime Minister, thus paving the way for the survival of the governing coalition between the PSD and the PP. However, when local elections took place on 29 September 2013, the PSD lost almost a third of the municipalities that it previously held. However, opinion polls taken during the crisis did not show much of an increase in support for the country's main opposition party, the PS, supporting the view that the electorate does not, at least for now, feel that the opposition presents a viable alternative to the current government and suggesting that early elections are unlikely, unless the economy takes a resolute turn for the worse.

There is however a possibility that a re-awakening of the political instability experienced during Summer 2013 before the next parliamentary elections due in June 2015, could result in early elections. That could, in turn, limit Portugal's ability to make progress towards regaining full market access by end 2014 as envisaged under the EFAP. The risks could be exacerbated if fiscal slippage calls for more draconian austerity measures to be adopted next year, just as Portugal is due to exit the current EFAP.

Portugal: Selected Indicators

For the year ended December 31

(EUR billions unless otherwise noted)	2007	2008	2009	2010	2011	2012
Public Sector Debt						
General Government Gross Debt	115.8	123.3	141.1	162.5	185.2	204.8
% GDP	68.4%	71.7%	83.7%	94.0%	108.4%	124.0%
General Government Net Debt	107.8	116.1	134.3	154.8	167.3	185.6
% GDP	63.7%	67.5%	79.7%	89.6%	97.9%	112.4%
Central Government Gross Debt	112.6	120.2	137.3	158.9	182.0	204.2
% GDP	66.5%	69.9%	81.5%	91.9%	106.4%	123.7%
Domestic Debt						
General Government	n.a.	n.a.	42.3	66.0	86.5	73.0
% GDP	n.a.	n.a.	25.1%	38.2%	50.6%	44.2%
External Debt						
General Government	n.a.	n.a.	98.8	96.5	98.7	131.8
% GDP	n.a.	n.a.	58.6%	55.8%	57.8%	79.8%
Private Sector	n.a.	n.a.	281.7	300.0	272.8	253.5
% GDP	n.a.	n.a.	167.2%	173.6%	159.5%	153.5%
Gross External	340.0	384.9	377.2	399.3	395.4	388.6
% GDP	200.8%	223.8%	223.8%	231.0%	231.3%	235.4%
Private Sector Debt						
Household	150.3	157.8	160.7	162.5	158.4	150.9
% GDP	88.8%	91.8%	95.4%	94.0%	92.6%	91.4%
Non-Financial Firms	227.0	254.0	261.7	267.8	273.6	269.3
% GDP	134.0%	147.7%	155.3%	154.9%	160.1%	163.1%
Fiscal Balances (% GDP)						
Revenues	41.1%	41.1%	39.6%	41.6%	45.0%	41.1%
Expenditures	44.4%	44.8%	49.8%	51.5%	49.4%	47.5%
Interest Payments	2.6%	2.7%	2.7%	2.7%	3.8%	4.0%
Interest Payments (% Revenues)	6.3%	6.5%	6.8%	6.5%	8.5%	9.7%
Primary Balance	-0.6%	-1.0%	-7.5%	-7.1%	-0.6%	-2.5%
General Government Balance	-3.2%	-3.7%	-10.2%	-9.9%	-4.4%	-6.4%
Balance of Payments & Liquidity						
Current Account Balance	-17.1	-21.7	-18.4	-18.3	-12.0	-3.3
% GDP	-10.1%	-12.6%	-10.9%	-10.6%	-7.0%	-2.0%
Trade Balance (% GDP)	-7.5%	-9.5%	-7.0%	-7.2%	-3.8%	-0.1%
Net Foreign Direct Investment (% GDP)	-18.1%	-15.5%	-18.8%	-19.5%	-17.9%	-20.1%
International Reserves	7.8	8.6	11.1	15.7	16.5	17.2
International Investment Position	-148.8	-165.4	-186.0	-185.2	-179.4	-190.5
% GDP	-87.9%	-96.2%	-110.3%	-107.2%	-104.9%	-115.4%
External Assets	303.2	290.5	314.9	331.0	303.1	298.4
External Liabilities	450.2	450.3	495.1	507.1	473.0	479.6

Note: general government net debt as calculated by the IMF; private sector debt includes loans and securities other than shares of Households & NPISH and Nonfinancial corporations. Source: Ministerio das Financas, IGCP, Banco de Portugal, IMF, European Commission, ECB, Eurostat, Haver Analytics, DBRS.

Republic of Portugal

Report Date:
13 December 2013

Ratings

Issuer	Debt Rated	Current	2012	2011	2010
Portugal, Republic of	Long-Term Foreign Currency – Issuer Rating	BBB (low)	BBB (low)	BBB	A (low)
Portugal, Republic of	Long-Term Local Currency – Issuer Rating	BBB (low)	BBB (low)	BBB	A (low)
Portugal, Republic of	Short-Term Local Currency – Issuer Rating	R-2 (middle)	R-2 (middle)	Not rated	Not rated
Portugal, Republic of	Short-Term Foreign Currency – Issuer Rating	R-2 (middle)	R-2 (middle)	Not rated	Not rated

Notes:

All figures are in euros (EUR) unless otherwise noted.

This is an unsolicited credit rating. This credit rating was not initiated at the request of the issuer.

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