Press Release

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Insight beyond the rating.

DBRS Confirms Republic of Portugal's Rating at BBB (low), Stable Trend

Industry: Public Finance--Sovereigns

DBRS Ratings Limited (DBRS) has confirmed the Republic of Portugal's long-term foreign and local currency issuer ratings at BBB (low) and short-term foreign and local currency issuer ratings at R-2 (middle). The trends on all ratings remain Stable.

The rating confirmation reflects: (1) Portugal's commitment to improve its public finances and implement structural reforms, (2) the benefits of euro area membership, and (3) the moderate impact of age-related expenditures on the public finances over the long-term. However, these supportive factors are balanced by significant challenges, including: (1) elevated levels of public sector debt; (2) high private sector indebtedness, (3) an uncertain medium-term outlook for potential GDP and (4) remaining fiscal challenges.

The Stable trend principally reflects three factors, namely: (1) DBRS's assessment that Portugal has made substantial progress in narrowing the fiscal and the current account deficits, (2) the build-up of sizeable cash buffers, which reduce rollover risk in the short-term, and (3) the strengthening of the country's banking sector as a result of the restructuring and recapitalization measures.

Downward pressure on the ratings could materialise if growth significantly underperforms relative to current expectations or the commitment to fiscal consolidation weakens, thereby adversely impacting public debt dynamics. Conversely, the ratings could be subject to upward pressure if growth outperforms and Portugal's fiscal consolidation plans deliver a material reduction in the stock of debt.
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Portugal has made considerable progress toward restoring the sustainability of its public finances. The fiscal deficit declined from 11.2% of GDP in 2010 to 4.9% in 2013. Excluding the effect of one-offs, the deficit is expected to reach 3.7% of GDP in 2014. The consolidation so far has involved a reduction in the structural primary balance of 9 percentage points of potential GDP. Additional measures totalling 0.7% of GDP in 2015 aim to reduce the deficit further to 2.7% of GDP. The emerging economic recovery is expected to support fiscal consolidation. However, DBRS believes that the substantial reliance on cyclical factors to reduce the deficit next year suggests insufficient progress with respect to the structural deficit and carries material downside risks that if the economy underperforms, the target will not be reached.

Portugal has also experienced some success in rebalancing the economy towards the tradable sector. The current account balance (according to the Banco de Portugal measure) improved from a deficit of 10.6% of GDP in 2010 to a small surplus in 2013 and has stayed in positive territory in 2014H1. These represent the first current account surpluses in 30 years and reflect a marked improvement on the 2000-08 period when the current account deficit averaged around 10% of GDP. The turnaround in the current account deficit reflects a significant decline in the goods deficit and an improvement in the services surplus. While this is partly explained by substantial import compression, exports have also performed well, supported by improvements in unit labour costs and greater market diversification.

Moreover, DBRS believes that membership of the euro area confers material benefits on Portugal. It facilitates trade flows and lowers interest rates. In addition, the European Financial Stability Facility (EFSF) and European Financial Stabilisation Mechanism, in coordination with the International Monetary Fund (IMF), provided Portugal with a EUR 76.4 billion financing package in May 2011, helping cover sovereign funding needs through mid-2014. DBRS believes that so long as the country continues to adhere to fiscal consolidation and implement the structural reform agenda, it is reasonable to assume that its euro area partners would agree to provide the country with additional official sector financial support were Portugal to be shut-off from the sovereign bond markets. DBRS also sees the maintenance of an adequate cash buffer as supportive of the rating. Finally, Portugal's relatively modest refinancing needs for 2015, the long average maturity structure of its debt stock, and the material share of total debt accounted for by official sector lending, provide further support to the rating.

The relatively benign outlook for the long-term sustainability of age-related spending is an underlying credit strength. The European Commission estimates age-related expenditure in Portugal will increase from 26.0% of GDP in 2010 to 26.1% by 2060. This compares favourably with the 3.7 percentage points projected increase for the EU27. However, there are emerging downside risks to these estimates as Portugal's population has recently declined more severely than previously anticipated, thus putting pressure on the dependency ratio.

Finally, the health of the financial sector has improved as a result of the restructuring and recapitalization efforts carried out by the banks in the last few years. The improvements in the sector were reflected in the results of the ECB asset quality review for the sector as a whole. The developments relating to the collapse of Banco Espirito Santo (BES) earlier in the year, which resulted in the government having to inject EUR3.9 billion into the newly created Novo Banco did not generate widespread contagion. In addition, the links between the sovereign and the banking sector have abated somewhat as a result of progression towards the adoption of the Single Resolution

Mechanism (SRM) and the creation of the Banking Sector Restructuring Fund (FRB).

Notwithstanding these supporting factors, Portugal's rating continues to be constrained by several factors. First, additional fiscal adjustment is needed. This could be difficult given the approaching parliamentary elections and the Constitutional Court's resistance to some of the expenditure cuts proposed to date, which are believed to impinge on the acquired rights of public sector workers or to affect those on lower incomes in a disproportionate manner. Public debt dynamics continue to be exposed to several downside risks. Failure to adhere to the planned fiscal consolidation measures in the run-up to the 2015 general election could result in a larger than expected deficit next year. Moreover, some uncertainty remains as to how the government will be able to reduce expenditure further in line with the consolidation plans set out in the April 2014 Stability Programme. Finally, growth prospects could be constrained by the high levels of household and corporate sector indebtedness and are vulnerable to external shocks. In particular, Portugal is exposed to the potential loss in growth momentum in its main trading partners, notably Spain, France, Germany and Italy.

Notes:
All figures are in Euro unless otherwise noted.

The principal applicable methodology is Rating Sovereign Governments, which can be found on the DBRS website under Methodologies. The principal applicable rating policies are Commercial Paper and Short-Term Debt, and Short-Term and Long-Term Rating Relationships, which can be found on our website under Rating Scales.

These can be found on www.dbrs.com at:
http://www.dbrs.com/about/methodologies

The sources of information used for this rating include IMF, OECD, BIS, European Commission, European Central Bank, Statistical Office of the European Communities, and Ministry of Finance of the Republic of Portugal, IGCP, Bank of Portugal, Unidade Tecnica de Apoio Orçamental (UTAO) and Haver Analytics. DBRS considers the information available to it for the purposes of providing this rating was of satisfactory quality.

DBRS does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

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For additional information on this rating, please refer to the linking document under Related Research.

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Lead Analyst:
Carla Clifton
Assistant Vice President
Initial Rating Date: 11 November 2011
Rating Committee Chair: Roger Lister, Managing Director.
Last Rating Date: 16 May 2014

DBRS Ratings Limited
1 Minster Court, 10th Floor
Mincing Lane
London
EC3R 7AA
United Kingdom

Registered in England and Wales: No. 7139960

Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Portugal, Republic of	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (low)	Stb	Nov 21, 2014

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Portugal, Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Nov 21, 2014
Portugal, Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 (middle)	Stb	Nov 21, 2014

The full report providing additional analytical detail is available by clicking on the link under Related Research at the right of the screen or by contacting us at info@dbrs.com.

Carla Clifton
Assistant Vice President - Global Sovereign Ratings Group
+44 20 7855 6647
cclifton@dbrs.com

Michael Heydt
Vice President – Global Sovereign Ratings Group
+1 212 806 3210
mheydt@dbrs.com

Fergus J. McCormick
Senior Vice President - Head of Sovereign Ratings
+1 212 806 3211
FMcCormick@dbrs.com

Alan G. Reid
Group Managing Director – Financial Institutions and Sovereign Group
+1 212 806 3232
areid@dbrs.com

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