Press Release

Date of Release: November 30, 2012

DBRS Confirms Portugal at BBB (low) with Negative Trend

Industry: Public Finance--Sovereigns, Sovereign Finance

DBRS, Inc. (DBRS) has today confirmed the Republic of Portugal's long-term foreign and local currency issuer ratings at BBB (low) and assigned a Negative trend to both ratings. DBRS has also confirmed the short-term foreign and local currency issuer ratings at R-2 (M) and assigned a Negative trend to both ratings. This concludes the Under Review with Negative Implications for all ratings.

The confirmation reflects DBRS's assessment that, despite an unfavourable external environment, Portugal has made significant progress consolidating public finances, unwinding external imbalances and implementing structural reforms. The statement from Euro area countries that additional financing would be available to Portugal, if necessary, as long as there is strict policy implementation in the context of the EU-IMF programme, provides additional support to the ratings.

The Negative trend, however, recognises that there is substantial uncertainty regarding Portugal's growth outlook with downside risks emanating from external demand, stressed economy-wide funding conditions and adverse effects from the fiscal consolidation effort. In particular, an intensification of the Euro area crisis would have negative implications for Portugal's growth prospects through trade, financial and confidence channels, making fiscal consolidation more difficult and adversely affecting Portugal's efforts to stabilise its public debt.

Deterioration in public debt dynamics due to fiscal slippage, the materialisation of contingent liabilities or a worsening of the growth outlook would lead to a downgrade of the ratings, unless there were indications of greater external support to help Portugal cope with the added debt burden. On the other hand, the trends could be changed from Negative to Stable if the political commitment to correct fiscal imbalances is sustained and downside risks to the growth outlook diminish. In this context, measures taken at the European level to resolve the Euro area crisis could facilitate Portugal's macroeconomic adjustment and help stabilise the ratings.

Growth projections for the Portuguese economy have been revised downwards since DBRS's last review. The IMF expects the Portuguese economy to contract 1.0% in 2013. Fiscal tightening and private sector deleveraging are contributing to a sharp decline in domestic demand. This has been accompanied by further deterioration in the labour market, partly reflecting a rebalancing of the economy away from the labour-intensive non-tradable sector toward the export sector. The

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unemployment rate increased to 15.8% in the third quarter of 2012, up from 12.4% one year earlier. Moreover, credit continues to contract amid high lending rates and tight credit standards. Supply-side credit constraints, particularly as the banking system deleverages, could intensify and prolong the economic downturn.

The contraction in domestic demand has been partially offset by net export growth. Exports performed well in 2011 and the first half of 2012, expanding 7.5% and 6.4%, respectively. However, export momentum is slowing and the growth outlook for the euro area has deteriorated. The IMF expects Spain, Portugal's largest trading partner, to contract 1.5% this year and 1.3% next year. Concerns over sovereign debt sustainability and financial sector fragility in the Euro area, combined with uncertainty over the future of Greece, also pose significant downside risks to growth.

Weak domestic demand and rising unemployment are also complicating efforts to correct fiscal imbalances, despite strong policy action. Tax revenues are expected to fall short of plan by 1.6% of GDP in 2012, reflecting weakness in VAT and corporate income tax receipts. Higher unemployment has led to reduced social security contributions and increased outlays. Consequently, the deficit – excluding one-off measures – is expected to narrow to 6.0% of GDP in 2012, above the initial target of 4.5%. Moreover, the size and composition of the planned adjustment in 2013 raise significant implementation risks, in DBRS's view.

With weaker growth and a slower fiscal adjustment, the IMF now expects general government debt to peak at 122% of GDP in 2013-14, slightly above DBRS's previous expectations. DBRS recognises that risks to this assessment are to the downside. A deeper recession than currently envisaged would make it more difficult to correct fiscal imbalances and stabilise debt dynamics over the medium term. Moreover, sizable contingent liabilities could add to the public debt burden.

Nevertheless, the coalition government has displayed a firm commitment to put public finances on a sustainable path and implement structural reforms. The structural primary balance narrowed 6.4% of potential GDP over the course of 2011 and 2012, principally through cuts in expenditure. As a result, nearly two-thirds of the cumulative adjustment from 2010 to 2014 has been completed. Moreover, fiscal consolidation is being reinforced with reforms to the fiscal framework that will improve budgetary execution across all levels of government, including state-owned enterprises. In DBRS's view, the fiscal adjustment, despite being slower than anticipated, could prove more durable than previous attempts.

The government has also passed structural measures to boost growth over the medium term. Labour reforms have reduced employment protections, revised unemployment benefits and introduced more

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work-time flexibility. These measures, combined with product market reforms, aim to foster competition and enhance productivity growth.

In addition, the external adjustment is proceeding at a rapid pace. The current account deficit narrowed from 10.0% of GDP in 2010 to 3.6% of GDP in the second quarter of 2012. Preliminary data suggests that further rebalancing took place in the third quarter. The adjustment has been driven by both strong export growth and import compression. Rapid export growth to markets outside the European Union, particularly Angola, China and the United States, has helped offset the slowdown in exports to Europe.

Given Portugal's weak growth outlook in the short term, it is not clear, in DBRS's view, if Portugal will be able to utilise affordable market-based financing on the scale necessary to cover its gross financing needs as the EU-IMF programme expires. Nevertheless, the ratings incorporate DBRS's expectation that additional financing would be provided to Portugal, if necessary, as long as the performance criteria and structural benchmarks are largely met, as outlined in the programme.

Notes:
All figures in Euros 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.

The sources of information used for this rating include the Portuguese Treasury and Government Debt Agency, Ministry of Finance, Bank of Portugal, IMF, European Commission and Haver Analytics. DBRS considers the information available to it for the purposes of providing this rating was of satisfactory quality.

This rating is endorsed by DBRS Ratings Limited for use in the European Union.

Lead Analyst: Michael Heydt
Rating Committee Chair: Alan G. Reid
Initial Rating Date: 10 November 2010
Most Recent Rating Update: 16 November 2012

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

Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Portugal, Republic of	Long-Term Foreign Currency - Issuer Rating	Confirmed	BBB (low)	Neg	Nov 30, 2012
Portugal, Republic of	Long-Term Local Currency - Issuer Rating	Confirmed	BBB (low)	Neg	Nov 30, 2012
Portugal, Republic of	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-2 (middle)	Neg	Nov 30, 2012
Portugal, Republic of	Short-Term Local Currency - Issuer Rating	Confirmed	R-2 (middle)	Neg	Nov 30, 2012

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