Notes on the State Budget Report for 2017

- **On October 14th, the Government submitted to Parliament the State Budget Report for 2017, anticipating a deficit of 2.4% of GDP this year (the lowest since 1989) and a reduction to 1.6% in 2017, which encompasses a structural adjustment of 0.6pp of potential GDP**
- **The macro scenario points to a moderate recovery, with GDP growing 1.2% in 2016 and 1.5% in 2017, on the back of a positive performance of both domestic and external demand**
- **In 2017, the State's gross financing needs shall stand at around €18 bn, to be mainly financed by the issuance of MLT debt of about €16 bn (€2 bn lower than in 2016)**
- **IGCP will sustain a strategy aimed at maintaining a comfortable cash position and gradually pre-paying the IMF loan (about €1.5 bn projected in 2017)**

Macro scenario foresees a moderate acceleration of GDP growth

On October 14th, the Government submitted to Parliament the 2017 Budget Report. The macroeconomic scenario forecasts an acceleration of GDP growth to 1.5% in 2017, up from expected 1.2% in 2016.

Domestic demand will keep its contribution to GDP growth at 1.3pp, as the slowdown in private consumption (from an annual growth rate of 2.0% in 2016 to 1.5% in 2017) will be compensated by an increase of 3.1% of investment (after a decline of 0.7% in 2016).

Macroeconomic Scenario

	INE - Statistics Portugal		2017 State Budget Report		Banco de Portugal		Portuguese Public Finance Council		European Commission	
			October 2016		Oct 2016	June 2016	September 2016		May 2016	
	2014	2015	2016P	2017P	2016P	2017P	2016P	2017P	2016P	2017P
Real GDP (yoy%)	**0.9**	**1.6**	**1.2**	**1.5**	**1.1**	**1.6**	**1.0**	**1.3**	**1.5**	**1.7**
Private Consumption	2.3	2.6	2.0	1.5	1.8	1.7	2.1	2.0	1.8	1.7
Public Consumption	-0.5	0.8	0.6	-1.2	1.0	0.4	0.2	0.1	0.6	0.4
GFCF	2.3	4.5	-0.7	3.1	-1.8	4.3	-0.3	2.9	1.6	4.9
Exports	4.3	6.1	3.1	4.2	3.0	4.7	3.7	3.8	4.1	5.1
Imports	7.8	8.2	3.2	3.6	3.0	4.9	3.8	4.0	4.3	5.6
Contributions to GDP growth (pp)										
Domestic demand	2.2	2.6	1.3	1.3	-	-	1.2	1.5	1.5	1.9
Inventories	0.1	0.0	-	-	-	-	-	-	0.0	0.0
Net exports	-1.4	-1.0	-0.1	0.2	-	-	-0.1	-0.2	-0.1	-0.1
External sector (% GDP)										
Current account	-0.3	-0.3	0.5	1.0	-	-	-	-	0.3	0.5
of which Goods and Services	0.2	0.7	1.5	1.9	2.1	1.3	1.1	1.3	-	-
Capital account	1.3	1.2	1.2	1.2	-	-	-	-	-	-
Unemployment (% labor force)	**13.9**	**12.4**	**11.2**	**10.3**	**11.2**	**-**	**11.4**	**10.7**	**11.6**	**10.7**
Prices (yoy%)										
GDP deflator	0.8	2.1	2.0	1.5	-	-	1.4	1.1	1.4	1.5
HICP	-0.3	0.5	0.8	1.5	0.7	1.4	0.8	1.0	0.7	1.2

Source: Statistics Portugal, Ministry of Finance, Banco de Portugal, Portuguese Public Finance Council and European Commission.

GDP is projected to grow 1.2% in 2016 and 1.5% in 2017 (in line with the most recent BdP projections)

GDP growth acceleration will benefit from a positive contribution of net exports (-0.1pp in 2015 to 0.2pp in 2016), resulting from a stronger growth of exports than imports. This will contribute to an improvement of the external accounts, with the net external financial capacity at 2.2% of GDP in 2017 (0.5pp above 2016).

External accounts in surplus for the 5th consecutive year …

According to most recent data, despite both exports and imports recently exhibiting downward paths in nominal terms (largely reflecting price declines in the energy component), exports have been decreasing at a slower pace, which allowed for an exports-to-imports ratio of 105.4% until July 2016 (which compares with 103.8% in the same period of 2015).

Regarding the labor market, the unemployment rate was revised downwards in 2016 to 11.2% of labor force, as the most recent figure published by Statistics Portugal points to 10.8% in 2016Q2 (1.6pp below Q1 and 1.1pp below 2015Q2). The unemployment rate is expected to continue on a declining trend in 2017 (reaching 10.3%), on the back of a healthy pace of job creation (0.8% in 2016 and 1.0% in 2017).

…continue to support a positive labor market performance

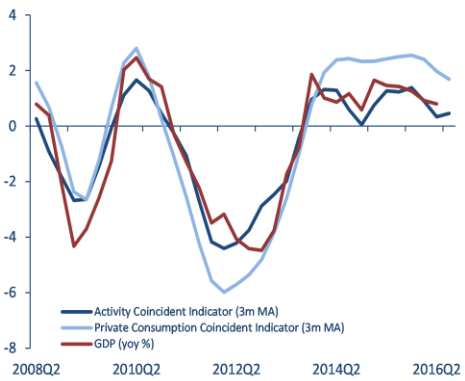
Inflation is expected to increase, from an average annual growth rate of 0.8% in 2016 to 1.5% in 2017. Over this year the HICP inflation has slightly increased (from 0.3% yoy in December 2015 to 0.7% in September), which compares with a marginal increase in the euro area (from 0.2% to 0.4% over the same period). Core HICP presented a similar trend, increasing 0.3pp over the year to 0.7% yoy in September.

As in previous years, the GDP deflator inflation will be higher than HICP inflation in 2016, on the back of an improvement in the terms of trade that is likely to be translated into improved profitability of domestic firms. For 2017, GDP deflator inflation and HICP inflation are expected to be similar.

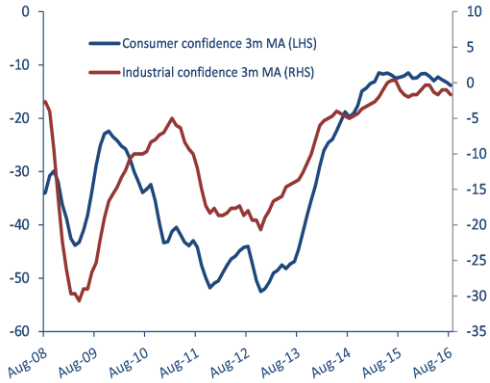
High frequency indicators point to a steady recovery. While the coincident indicator on economic activity has been increasing since July, consumer and industrial confidence have stabilized at relatively high levels, by historical standards.

High frequency indicators continue to signal a stable growth environment

GDP and coincident indicators
(%)



Consumer and industrial confidence
(balance between positive and negative assessment)



Source: Statistics Portugal and Banco de Portugal

Deficit expected to stand at 2.4% of GDP in 2016 and to decline to 1.6% in 2017

Along with the 2017 Budget submitted to Parliament, the Government has also submitted the Draft Budgetary Plan to the European Commission, in compliance with the European Semester rules, and the Effective Action Report, reaffirming its commitment to comply with the European framework established under the Fiscal Compact.

In 2016 the headline deficit will stay below the European Commission target of 2.5% and the structural deficit will post a positive adjustment of 0.2pp of potential GDP

In 2016, the budget deficit is expected to stand at 2.4% of GDP, settling below the 3% threshold for the first time since entering the European Monetary Union. This is achieved without the need for additional measures, except that it has permanently frozen appropriations amounting to €445 mn (about 0.2pp of GDP), out of a total of €1.6 bn originally included in the Budget (€666 mn remain available).

For 2017, the deficit shall be reduced to 1.6% of GDP, an adjustment of 0.9pp relative to 2016. The primary balance is expected to reach a surplus 2.8% of GDP, which compares with 1.9% in 2016.

In 2017, the Government foresees a structural adjustment of 0.6pp of potential GDP, in compliance with the EU Fiscal Compact rules

The structural overall balance is expected to improve 0.6pp of potential GDP, having as reference the potential output estimated in the Stability Program.

OVERALL BALANCE								
	2010	2011	2012	2013	2014	2015	2016^{p}	2017^{p}
Overall balance	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.4	-1.6
Structural overall balance	-8.6	-5.7	-3.0	-2.6	-1.4	-1.9	-1.7	-1.1

PRIMARY BALANCE								
	2010	2011	2012	2013	2014	2015	2016^{p}	2017^{p}
Primary balance	-8.2	-3.1	-0.8	0.0	-2.3	0.2	1.9	2.8
Structural primary balance	-5.6	-1.4	1.9	2.3	3.5	2.7	2.7	3.2

Source: Statistics Portugal and Ministry of Finance

This evolution reflects an increase in revenue by 0.5pp of GDP, coupled with a reduction of the weight of expenditure on GDP by 0.4pp.

On the revenue side, current revenue will increase from 42.7% of GDP in 2016 to 43.1% in 2017.

The fiscal policy mix will again be tilted to more indirect taxation, to compensate for lower direct taxation

The weight of current taxes on income and wealth on GDP will decrease 0.1pp in 2017, mainly reflecting the gradual removal of the personal income tax surcharge (€-200 mn).

In the case of taxes on production and imports there will be a negative impact stemming from the reduction of the VAT rate on restaurants that entered into forced in July 2016 (€-175 mn), that will be fully compensated by the additional to the property tax[1] (€160 mn), tax on soft drinks and other sugary drinks and the recomposition of the tax on oil products.

In addition, the Government will implement a special program for reducing tax and social contribution liabilities to the State (*PERES*) (€100 mn).

[1] *State surcharge on real estate property municipal tax (IMI): the tax base consists in the sum of the tax asset values, as of January 1st of the year to which the additional property tax is concerned. To the tax assets value is deducted €600,000, and after implementing the deductions, the rate of 0.3% is applied.*

The weight of other current revenues on GDP will rise by 0.5pp, due to the evolution of revenue sources other than taxes, namely the expected increase on the dividends received from *Banco de Portugal* (€300 mn).

The capital revenue weight on GDP will remain unchanged. This item includes the reimbursement of pre-paid margins by the ESM in 2016 (€264 mn), and the recovery of the BPP guarantee in 2017 (€450 mn).

In 2017, the expenditure review will be expanded, allowing for further efficiency gains and savings in other sectors of public administration

On the expenditure side, the weight of current expenditure is estimated to decrease 0.6pp of GDP, while capital expenditure will increase 0.2pp.

The weight of social benefits will contract 0.3pp of GDP, explained by the improvement in the labor market, which will reduce the spending on unemployment benefits and other cyclical measures. These effects are expected to more than compensate the pensions' update (€187 mn) and new single social benefit for disabled (€60 mn).

The compensation of employees will decrease 0.2pp of GDP between 2016 and 2017, resulting from the control of public employment, by hiring only one employee per two leaving the service (€-122 mn), which will partially compensate the full implementation of the reversal of wage cuts (€257 mn in gross terms, or €181 mn netting out the favorable impact on the revenue side), and the 35 hours week in the health sector (€25 mn).

In what regards intermediate consumption, its weight is expected to decrease by 0.1pp of GDP due to the improvement in public services efficiency and cost constraints in specific services of public administration (€-75 mn) - health sector, education sector and State Owned Enterprises.

General Government Account (accrual basis)									
(% GDP)	2010	2011	2012	2013	2014	2015 P	2016 P	2017 P	2017 vs 2016
Total revenue	**40.6%**	**42.6%**	**42.9%**	**45.1%**	**44.6%**	**44.0%**	**43.6%**	**44.1%**	**0.5pp**
Current revenue	39.4%	41.5%	41.1%	44.0%	43.6%	43.2%	42.7%	43.1%	0.4pp
Current taxes on income and wealth	8.5%	9.5%	9.0%	11.4%	11.0%	10.8%	10.2%	10.2%	-0.1pp
Taxes on production and imports	13.2%	13.9%	13.9%	13.7%	14.2%	14.5%	14.8%	14.8%	0.0pp
Social contributions	11.9%	12.0%	11.4%	12.0%	11.8%	11.6%	11.6%	11.7%	0.0pp
Other revenue	5.8%	6.2%	6.9%	6.8%	6.6%	6.2%	6.0%	6.5%	0.5pp
Capital revenue	1.3%	1.1%	1.8%	1.1%	1.0%	0.9%	1.0%	1.0%	0.0pp
Total expenditure	**51.8%**	**50.0%**	**48.5%**	**49.9%**	**51.8%**	**48.4%**	**46.1%**	**45.7%**	**-0.4pp**
Current expenditure	44.6%	45.6%	45.3%	46.8%	45.6%	44.1%	43.7%	43.1%	-0.6pp
Social benefits	18.6%	18.9%	19.6%	20.4%	19.7%	19.3%	19.0%	18.7%	-0.3pp
Compensation of employees	13.7%	12.8%	11.7%	12.5%	11.9%	11.3%	11.2%	11.0%	-0.2pp
Interest (EDP)	2.9%	4.3%	4.9%	4.9%	4.9%	4.6%	4.3%	4.3%	0.0pp
Intermediate consumption	5.9%	6.0%	5.8%	5.6%	5.7%	5.8%	5.7%	5.6%	-0.1pp
Subsidies	0.7%	0.7%	0.6%	0.6%	0.7%	0.6%	0.6%	0.6%	0.0pp
Other current expenditure	2.8%	2.9%	2.7%	2.7%	2.7%	2.5%	2.9%	2.9%	0.0pp
Capital expenditure	7.2%	4.4%	3.3%	3.2%	6.2%	4.3%	2.4%	2.6%	0.2pp
Gross fixed capital formation	5.3%	3.5%	2.3%	2.3%	1.9%	2.3%	1.9%	2.2%	0.3pp
Other capital expenditure	1.9%	0.9%	1.0%	0.9%	4.2%	2.0%	0.6%	0.4%	-0.2pp
Overall balance	**-11.2%**	**-7.4%**	**-5.7%**	**-4.8%**	**-7.2%**	**-4.4%**	**-2.4%**	**-1.6%**	**0.9pp**
Memo items									
Primary expenditure	**48.9%**	**45.7%**	**43.6%**	**45.1%**	**46.9%**	**43.8%**	**41.8%**	**41.3%**	-0.4pp
Primary balance	**-8.2%**	**-3.1%**	**-0.8%**	**0.0%**	**-2.3%**	**0.2%**	**1.9%**	**2.8%**	**0.9pp**

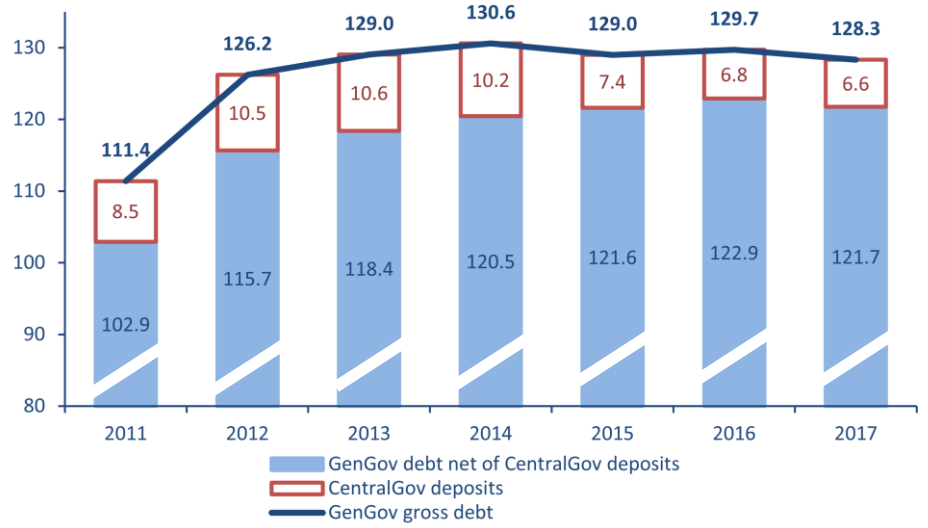
Source: Statistics Portugal and Ministry of Finance

Public debt projected to reach 128.3% of GDP in 2017

The Maastricht gross debt is expected to increase slightly to 129.7% of GDP in 2016, 0.7pp higher than in 2015, assuming the capitalization of CGD still occurs this year. In 2017, the debt-to-GDP ratio is expected to resume a downward trajectory, reaching 128.3% by the end of the year.

The public debt net of Central Government deposits is expected to stand at 121.7% of GDP in 2017, declining from 122.9% in 2016.

Maastricht public debt
(% GDP)



Public debt is projected to resume a declining trend in 2017, on the back of a strong primary surplus of 2.8% of GDP and nominal GDP growth of 3%

Source: Banco de Portugal and Ministry of Finance

The decomposition of debt dynamics shows that the slight increase expected to occur in 2016 results from one-off stock-flow adjustments, in particular the capitalization of CGD, which amounts to 1.5pp of GDP.

The reduction projected for 2017 is achieved on the back of a strong primary surplus of 2.8% of GDP, which more than offsets the snowball effect and unfavorable stock-flow adjustments, which mainly result from the difference between the deficit on a cash and accrual basis (the former is projected to be higher by 0.9pp of GDP).

Public debt dynamics (pp GDP)

	2014	2015	2016 P	2017 P
Maastricht debt (% GDP)	**130.6**	**129.0**	**129.7**	**128.3**
Change (pp GDP)	1.6	-1.6	0.7	-1.4
Primary balance effect	2.3	-0.2	-1.9	-2.8
Snowball effect	2.8	-0.1	0.3	0.6
Interest	4.9	4.6	4.3	4.3
Nominal GDP	-2.1	-4.7	-4.0	-3.8
Other stock-flow adjustments	-3.5	-1.3	2.3	0.8

Source: Ministry of Finance

2017 borrowing needs expected to be funded in 40% by the end of 2016

The State's net financing needs are projected to stand at €9.6 bn in 2017, about €3 bn lower than in 2016. This is mainly explained by the lower net acquisition of financial assets, as the 2016 figure is highly impacted by the planned capitalization of CGD using €2.7 bn of public funds.

Gross borrowing needs in 2017 are estimated at €18 bn (or about €16.5 bn excluding the repurchase of IMF loan)

Gross borrowing requirements shall stand close to €18 bn, given MLT debt redemptions of €6.8 bn (PGB maturing in October) and assuming €1.5 bn redemptions of IMF loans.

MLT debt financing is estimated to stand around €16 bn

The financing needs will be covered by MLT debt market issuance (€16 bn), retail debt net issuance (€1.5 bn) and a likely increase of the Tbills stock (€0.5 bn).

State Treasury borrowing needs and sources (€ billion)

	2015	2016 P	2017 P	2018 P	2019 P	2020 P
State borrowing requirements	**29.0**	**23.5**	**17.9**	**16.3**	**16.6**	**18.3**
Net financing needs	**11.8**	**12.3**	**9.6**	**4.5**	**4.7**	**2.8**
Overall deficit *	5.6	6.3	6.6	2.6	1.4	0.6
Other net acquisitions of financial assets **	6.2	6.0	3.0	1.9	3.4	2.2
MLT Redemptions	**17.2**	**11.3**	**8.3**	**11.8**	**11.8**	**15.5**
Tbonds (PGB + MTN)	8.8	9.3	6.8	8.3	10.2	10.7
IMF (executed)	8.4	2.0				
IMF (to be executed)		0.0	1.5	3.5	1.6	4.8
p.m. IMF (original maturity of outstanding loan)		*0.0*	*0.0*	*1.8*	*4.8*	*4.8*
State financing sources	**29.0**	**23.5**	**17.9**	**16.3**	**16.6**	**18.3**
Use of deposits	**5.8**	**0.1**	**-0.1**	**1.1**	**1.0**	**0.0**
Financing in the year	**23.2**	**23.4**	**18.0**	**15.2**	**15.6**	**18.3**
Executed	**23.2**	**20.4**				
Tbonds (PGB + MTN)	20.2	15.5				
FRN/*OTRV*		2.0				
Retail debt (net)	3.5	2.7				
Tbills (net)	-0.7					
Other flows (net)	0.2	0.2				
To be executed		**3.0**	**18.0**	**15.2**	**15.6**	**18.3**
Tbonds (PGB + MTN)		2.0	16.0			
Retail debt (net)		0.8	1.5			
Tbills (net)			0.5			
Other flows (net)		0.3				
State Treasury cash position at year-end ***	**6.6**	**6.5**	**6.6**	**5.5**	**4.5**	**4.5**

* State sub-sector cash deficit in 2015-17. Projection for GG deficit (excl SS) in 2018-20 (Stability Program, Apr 2016).

** Includes refinancing of other public entities (namely SOEs and regions), as well as loans to the Resolution Fund and direct capitalization of Banif in 2015, capitalization of CGD in 2016, and reimbursement of CoCos and credit line to the Single Resolution Board in 2017.

*** Excluding cash-collateral.

Source: IGCP

IGCP plans to sustain a strategy of pre-emptively covering the funding needs of upcoming years

Any pre-payments of the IMF loans are dependent on market conditions. Hence, the funding needs to be covered with MLT debt issuance in 2016 effectively amount to about €16.5 bn, of which about 40% are expected to be funded by the end of 2016.

2017 Budget report (in Portuguese only):

- http://www.dgo.pt/politicaorcamental/Paginas/OEpagina.aspx

2017 Draft Budgetary Plan and Effective Action Report:

- http://ec.europa.eu/economy_finance/economic_governance/sgp/budgetary_plans/index_en.htm

Further information on the Portuguese economy can be obtained from:

- **Ministry of Finance** http://www.portugal.gov.pt/pt/ministerios/mf.aspx
- **Banco de Portugal** www.bportugal.pt
- **Statistics Portugal** www.ine.pt
- **Public Finance Council** www.cfp.pt
- **UTAO (only in PT)** Website
- **Portugal Economy Probe** www.peprobe.com

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