

## Economics

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# Euro Weekly

## Portugal — Second Bailout and Debt Restructuring Likely

- In earlier assessments of its debt position, we argued that Portugal would not be able to move on to a viable fiscal path without a haircut of 35% by the end of 2012 or in 2013. While we acknowledge that Portugal is in many aspects different from Greece, we now conclude that the size of the haircut will need to be higher, to the tune of 50%, most likely taking the form of a reduction in the debt held by the private sector.
- If done in 2012, a 50% haircut in the nominal value of Portuguese government debt would help to cap the peak in the debt-to-GDP ratio at around 113% in 2015. Hence, in our scenario, Portugal will need around €70bn extra funding from the Troika (plus sweeteners for the PSI) in order to close the funding gap until the end of 2015.
- Unlike Greece, implementation issues are not a major impediment to fiscal consolidation. Instead, the main reason behind our baseline of a budget deficit overshoot is that the recession is intensifying and that GDP growth prospects remain weak over the medium term. Additional contingent liabilities from SOEs and PPPs will also require some financing. (Jürgen Michels and Guillaume Menuet, see page 2).

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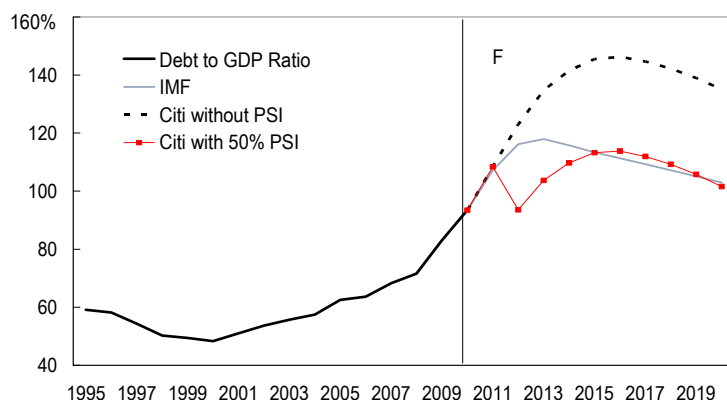
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**Figure 1. Citi Market Forecasts**

	\$/€	Euro Repo	10-yr Bunds	£/€	U.K. Bank Rate	10-yr Gilt-Bund	SKr/€	SEK Policy Rate	NOK/€	NOK Policy Rate	SFr/€	CHF Policy Rate	CHF Spread vs Bunds
<b>3Q 12</b>	1.30	0.50	1.50	0.82	0.50	20	8.80	1.00	7.50	1.50	1.21	0.00	-94
<b>1Q 13</b>	1.26	0.50	1.50	0.80	0.50	10	8.79	1.00	7.50	1.50	1.22	0.00	-86

Source: Citi Investment Research and Analysis

With thanks to Carla Clifton

**Figure 2. Portugal -- Debt Trajectory Troika Baseline and Citi Scenarios, 1995-2020F**


F: Forecast. Source: National sources and Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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## Portugal: Second Bailout and Debt Restructuring Likely

Investors remain unconvinced about Portugal's prospects. We maintain that a PSI will be necessary before Portugal can return to the market in 2013

We review the 2011 fiscal position and estimate the extent of the likely shortfall in 2012 that will require addressing

We raise our estimate of the necessary haircut from 35% to 50%

New government took a series of one-off corrective actions in 2011

In the aftermath of the Eurogroup's decision to approve a second bailout package for Greece, the Portuguese/Bund 10-year spread continues to trade above 1,000bp, suggesting that investors remain unconvinced about the country's debt sustainability. Our forecast of a deep recession in 2012/13, to be followed by weak economic growth thereafter, argues that Portugal is not on a sustainable fiscal path.

In this note, we review Portugal's performance against the 2011 fiscal targets, assess the likelihood of meeting the 4.5% budget deficit-to-GDP target for 2012, identify the factors that are likely to derail fiscal consolidation, estimate the likely size of the funding gap, and assess the country's debt dynamics under different assumptions about growth, yields and the size of contingent liabilities.

In earlier assessments of its debt position, we argued that Portugal would not be able to move on to a viable fiscal path without a haircut of 35% by the end of 2012 or in 2013. While we acknowledge that Portugal is in many aspects different from Greece, we now conclude that the size of the haircut will need to be raised to 50%, most likely taking the form of a reduction in the debt held by the private sector. We argue that the size of the haircut will depend on the macroeconomic situation, the amount of arrears that the government will need to settle, and the size of contingent liabilities that will require financing. In any case, assuming that market access cannot be regained before 2016, Portugal would need an extension in its official funding of between €50bn to €65bn.

### Portugal is expected to have met its 2011 targets

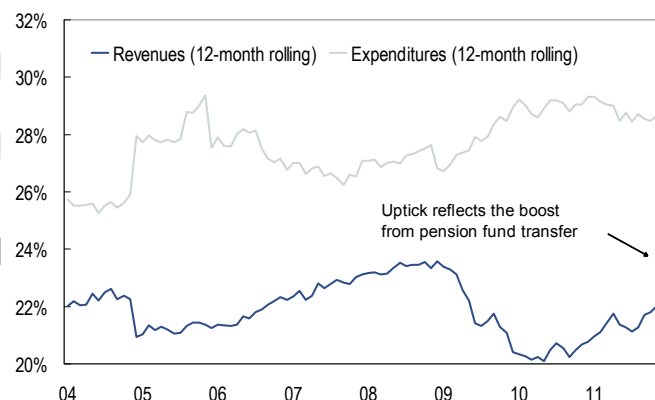
Despite a new government with a stronger focus on fiscal consolidation at the helm since June 2011, the deterioration in economic activity and the worsening euro area sovereign debt crisis meant that Portugal's fiscal adjustment program has been coming off the rails. As it became increasingly obvious that the government would miss its deficit target of 5.9% of GDP for 2011, newly elected PM Coelho pushed through additional revenue raising measures worth 0.6% of GDP. Furthermore, the government used one-off measures, e.g. the transfer of banks' pension funds to the government's social security budget, estimated by the IMF to have a net deficit reducing impact of around 1.9% of GDP (see Figure 3 below).

Figure 3. Portugal — Effect of One-Off Measures on Deficit (% of GDP)

	Programme	Without Pensions Transfer	With Pensions transfer
Total Revenue	41.8	41.6	43.5
Current Receipts	40.5	40.2	40.2
Capital Revenue	1.3	1.3	3.2
Total Expenditure	47.7	49.3	49.3
Primary Current Expenditure	40.6	40.9	40.9
Interest Payments (EDP)	4.2	4.2	4.2
Capital Expenditure	2.8	4.1	4.1
Overall Budget Balance (EDP)	-5.9	-7.8	-5.9

Sources: IMF, Second review December 2011 and Citi Investment Research and Analysis

Figure 4. Portugal — Expenditure and Revenue Trends (% of GDP), 2004-Dec-2011



Sources: Portuguese Finance Ministry and Citi Investment Research and Analysis

### Expenditure slippages and non-tax revenue shortages at the heart of the weakness

Analysis of expenditure developments through 2011 is not encouraging. Data on central government spending reported on a cash basis show that the administration only managed to reduce its outlays from 29.3% of GDP in December 2010 to 28.3% in December 2011 (see Figure 4 above). A non-exhaustive list of the main drivers behind this trend would include weak wage discipline, larger-than-expected capital transfers to State-Owned Enterprises (SOEs) because of impeded market access, and additional transfers to Public Private Partnerships (PPPs). Revenue trends were more encouraging, however, showing a 3.2ppt increase in general government revenues to 24% of GDP. Nevertheless, non tax-revenues expected from assets sales (privatizations) disappointed.

## 2012 the litmus test of Portugal's debt sustainability

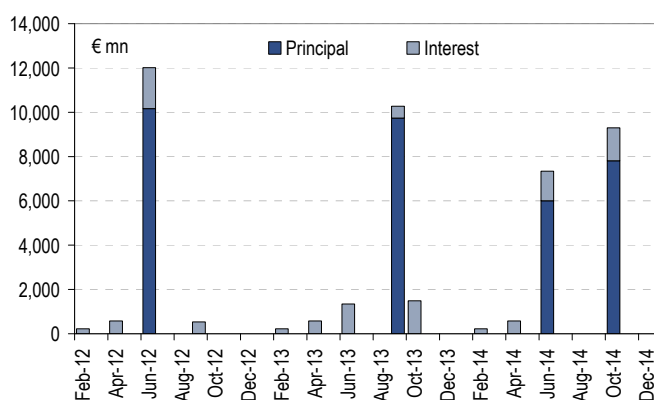
### Aggressive 2012 budget

Portugal has committed to an ambitious fiscal consolidation program in the 2012 budget<sup>1</sup>, resulting in savings worth 5.3% of GDP (€9.0bn). Two-thirds of the tightening is estimated to stem from a reduction in expenditures, with the single largest item a reduction in the public sector wage bill (including the suspension of the 13th and 14th monthly wages for two years) worth €1.6bn<sup>2</sup>. On the revenue side, the government expects to receive just over €2bn (1.2% of GDP) by moving categories of goods and services from the reduced (6%) and intermediate (13%) VAT rates to the maximum rate of 23%.

### Unlike Greece, Portugal's track record on implementation is respectable, but some slippage in 2012 is already acknowledged

Unlike in Greece, implementation issues are not a major impediment to fiscal consolidation. Instead, the main reason behind our forecast of a budget deficit overshoot is because we expect the recession to intensify, which will dampen revenues further. PM Coelho admitted at his party conference that on current policy assumptions his government would likely miss the 4.5% of GDP budget deficit target for 2012 to the tune of 0.7ppt. Despite this, PM Coelho continues to focus on the expenditure side of the equation, arguing that the budget overshoot is expected to be split roughly between extra provisions for the payment of newly transferred pensions (banks and telecom) and larger-than-expected outlays for the PPPs.

Figure 5. Portugal — Bond Redemptions Profile (€ mn), Feb-12-Dec-14



Sources: Bloomberg and Citi Investment Research and Analysis

Figure 6. Portugal — MoU Disbursement Schedule, Jun 2011-Jun 2014

1st Year		Jun-11	Sep-11	Dec-11
IMF (1/3)		6.4	3.9	2.7
EU (2/3)		12.3	7.6	5.3
Total		18.7	11.5	8
2nd Year	Mar-12	Jun-12	Sep-12	Dec-12
IMF (1/3)	4.9	1.3	1.4	0.8
EU (2/3)	9.7	2.6	2.8	1.6
Total	14.6	3.9	4.2	2.4
3rd Year	Mar-12	Jun-12	Sep-12	Dec-12
IMF (1/3)	4.9	1.3	1.4	0.8
EU (2/3)	9.7	2.6	2.8	1.6
Total	14.6	3.9	4.2	2.4
4th Year	Mar-14	Jun-14		
IMF (1/3)	0.8	0.9		
EU (2/3)	1.7	1.8		
Total	2.5	2.7		

Sources: IMF, EU, ECB and Citi Investment Research and Analysis

<sup>1</sup> Portugal's budget deficit in January totaled €436m, a drop of 41% compared to last year. According to the latest summary of budget execution from Directorate-General for the Budget (DGO), the drop was mainly due to expenditure falling 12.7% as compared to January 2011, as the States' revenues fell because of a 7.9% drop in tax revenues.

<sup>2</sup> Other sizeable measures include a reduction in pension payments (worth €0.9bn after losses in tax and social security contributions are taken into account), and a drop of €1bn in health spending.

**Without supplementary measures or a positive GDP growth surprise, Portugal will miss its budget deficit target**

We expect that without supplementary measures or an unlikely upside surprise in GDP growth, Portugal will fail to meet its fiscal consolidation objectives. Indeed, comments from the PM suggest that even in the case of a less dramatic recession — the government forecasts contraction of around 3% in 2012 — Portugal is unlikely to meet its public budget targets this year. The Troika's third review of the Portuguese adjustment program is expected in March. We believe that its findings will probably highlight the need for immediate contingency measures, which, after they are approved in parliament, will allow the disbursement of the large March tranche worth €14.6bn designed to cover the €10.1bn June 15 redemption (see Figures 5 and 6 above).

## **Quantifying Portugal's vulnerabilities**

In addition to the downside risks for economic activity in 2012-2013, the Troika identified several risks to Portugal's fiscal consolidation program and long-term debt sustainability in its December 2011 review. The most material risks included:

- (i) Potential overspending by the country's large number of State-Owned Enterprises (SOEs), many of which are now cut off from the markets;
- (ii) The increasing liabilities associated with the very large stock of Public Private Partnerships (PPPs);
- (iii) Potential unfunded pressures from larger-than-currently anticipated bank recapitalizations; and
- (iv) The need to settle vast amounts of arrears accumulated by the central government, the SOEs and the autonomous regions.

### **Why are SOEs a risk and how big could the liabilities turn out to be?**

**SOE transfers affect general government expenditure and guarantees are counted as contingent liabilities**

According to the IMF, SOEs are concentrated in the transport and health sectors, representing 4.5% of GDP and 3.5% of total employment. Many SOEs were in recent years re-classified from the private sector to the general government. This situation has led to an increase in general government expenditure when transfers and subsidies were directed towards some of these loss-generating entities. For example, in 2010 (the last year when the full audited amounts are available) SOEs cost the general government €323mn. But more importantly, since the government also provided guarantees for SOEs, it has contingent liabilities and might be forced to take over the debt. According to IMF estimates, explicit guarantees to SOEs (including those outside general government accounts) represented between 10% and 15% of GDP in mid-2011.

**Not only is the regional dimension also a matter of concern, SOEs also tend to crowd out private sector borrowers**

The regional dimension of the SOEs in Portugal is also a matter for concern. Thanks to the guarantees from autonomous regions (which themselves rely on the sovereign as an implicit and ultimate guarantor), many SOEs have been able to run large deficits and finance themselves at low rates. In the current climate of very tight credit conditions, the reliance of SOEs on bank funding has also tended to crowd out private sector borrowers.

### **Why are PPPs a risk and how big could the liabilities turn out to be?**

**The widespread reliance on PPPs will result in substantial liabilities in the short and medium term**

Like SOEs, Public Private Partnership (PPPs) have also been flagged up by the Troika as posing substantial risks to the government's fiscal adjustment plan. PPPs became a popular way to finance investment in infrastructure in Portugal in the early 2000s before re-gaining popularity from 2008. One of their main features is that the government pays rents to the private companies running the infrastructure over an extended period of time. This often means that while they are expected to

eventually generate funding for the government when the leases to the private sector run out (and it can dispose of the assets), they can constitute substantial liabilities in the short and medium term.

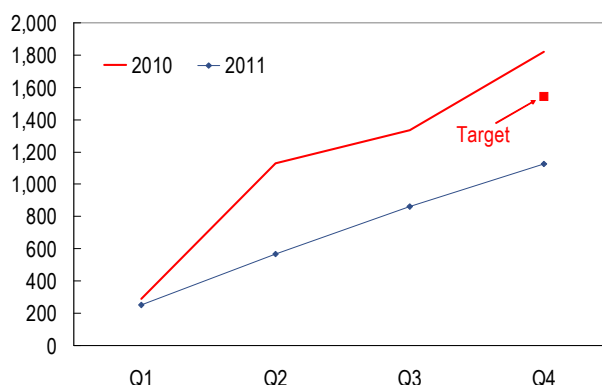
**Troika's estimates of the PPPs liabilities sizeable but still likely to underestimate actual costs**

According to the Troika, PPP-related outlays will increase substantially over time, peaking at around 1% of GDP in the middle of the decade (2015-17). Of course these estimates are based on a more benign economic outlook than in our baseline. Considering that the PPP program has about between 13% and 14% of GDP in depreciated investments, the Troika believes that this would be the maximum exposure for Portugal over the next 30 years or so (See Figure 7). However, these latest Troika estimates probably will prove still too optimistic<sup>3</sup>. For example, the data on the cost of PPPs in 2011 shows that the outturns exceeded the estimated costs by 18% (Figure 8) due to an overspending of 30% by transport-related PPPs as the government had to assume responsibility for the funding of investments whose future was deemed to be at risk.

**Figure 7. Portugal – Estimated liabilities from Public Private Partnerships (PPPs), 2010-2051**

	€ bn	% of GDP
2010	0.94	0.56
2011E	1.59	0.94
2012F	1.04	0.62
2013F	0.90	0.53
2014F	1.42	0.84
2015F	1.54	0.91
2016-2021F Annual Average*	1.35	0.80
2011-2051F	26.01	15.10

**Figure 8. Portugal – Accrual of PPP Liabilities (€ mn), 2010-2011**



Sources: Portuguese Finance Ministry and Citi Investment Research and Analysis

Sources: Finance Ministry and Citi Investment Research and Analysis

### What about the banks?

**Recapitalization of the country's banks could be higher than assumed**

Bank recapitalizations are expected by the Troika to add 4.7% of GDP to the stock of debt in 2012. With a larger-than-expected deterioration of the economy and a likely corresponding increase in non-performing loans, Portuguese banks' capital requirements will probably be even larger. However, easier access to cheap Eurosystem funding through the widened eligible collateral pool should help to restore some profitability for Portuguese banks and might cap the additional capital requirements.

### Could the payment of arrears add to the pressures?

**Payment of arrears could result in non-compliance with Troika targets and additional austerity**

Arrears make up a substantial portion of the difference between the deficit reported on a cash basis and the deficit reported on an accruals basis. The measure used by the Troika and the EU to monitor Member States' compliance with the deficit targets is the broader European System of Accounts (ESA) measure, which includes arrears. However, the deficit figures reported on an ESA basis are always reported with a lag and as a result we do not yet have a full picture of the impact of arrears

<sup>3</sup> The Government commissioned an in-depth independent study by an international firm (due later this year) on the projected costs of the country's PPPs which should give greater clarity on the exact size of the future liabilities.

payments on the 2011 deficit. According to the IMF, arrears continued to increase in Q3 2011, resulting in the country breaching its indicative ceiling for end-September 2011. Moreover, the Portuguese authorities also revised up their estimates of the stock of arrears to 3.2% of GDP in 2011. Note that while the 2012 budget does not include specific plans to settle the payment of the existing stock of arrears, the authorities are committed to do this over time as part of the program requirements.

### Could privatization revenues make a difference?

**The will is there but the size of the assets stock is small and sales could be delayed**

Portugal has made some progress with its assets sale and privatization program in 2011. However, difficult market conditions have restricted the amount raised by real estate disposals. Hence, we regard the government target for privatization revenues, which are also included in the Troika central scenario, of 2.4% of GDP (or €4.1bn) in 2012 and 0.6% of GDP (or €1.0bn) in 2013 as too optimistic. However, a mitigating factor is the relatively small size of the total stock of assets that the government is expected to sell for the duration of the current Troika program (compared to Greece especially), amounting to only €5.6bn (3.2% of GDP).

### Delay in access to market funding

**Troika assumes medium and long term bond issuance from mid-2013**

The Troika program envisages a return to the market for medium- and long-term debt issuance by Portugal from 2013 onwards (see Figure 9 below).

**But we do not expect Portugal to be able to access the markets from next year**

Over the 2013 to 2016 period, the IMF assumes that Portugal will be able to raise some €65bn in medium- and long-term financing, starting with €9.3bn in 2013. However, we believe that this target will be impossible to achieve as early as next year, or at least not at rates that Portugal could afford over the medium term. So even if the deficit is in line with the Troika's base case, there would be a funding gap in 2013. Similar to the developments in Greece, the IMF at some stage in the course of 2012 (maybe as early as in the March review) will have to address this, since a continuation of the program disbursements can only take place if the overall funding over the upcoming 12 months is secured.

**Figure 9. Portugal — Public Sector Financing Requirements, 2011-2016**

€ billions	2011	2012	2013	2014	2015	2016	2013-16
Overall Balance	10.1	7.6	5.2	4.1	3.4	3.4	16.1
Amortization	29.6	25.6	22.8	27.2	24.1	35.0	109.1
Other	13.5	9.0	5.4	2.8	0.0	0.0	8.2
Gross Borrowing Need	53.2	42.2	33.4	34.1	27.5	38.4	133.4
Privatizations	0.5	4.1	1.0	0.0	0.0	0.0	1.0
Market Access	14.6	13.0	22.3	28.9	27.5	38.4	117.1
• ST	12.9	13.0	13.0	13.0	13.0	13.0	52.0
• M & LT	1.7	0.0	9.3	15.9	14.5	25.4	65.1
Gross Financing Sources	15.1	17.1	23.3	28.9	27.5	38.4	118.1
Financing Gap	38.1	25.1	10.1	5.2	0.0	0.0	15.3
• EU	25.4	16.7	6.7	3.4			
• IMF	12.7	8.3	3.3	1.7			

Sources: Troika 2<sup>nd</sup> review and Citi Investment Research and Analysis

**Figure 10. Portugal — Citi's Assumptions on Contingent Liabilities, 2011-2016**

% of GDP	2011	2012	2013	2014	2015	2016
Privatisations (-)	0.3	2.3	0.4	0.2	0.2	0.2
Cost of Bank Recaps (+)	6.4	5.4	2.4	0.6	0.5	0.5
SOE Liabilities Source (+)	1.0	1.3	0.5	0.5	0.5	0.5
PPPs Liabilities (Gross) (+)	1.0	1.3	1.3	1.6	1.7	0.7
Net total	8.1	5.8	3.8	2.5	2.5	1.5
Cumulative		13.9	17.7	20.2	22.7	24.2
Cumul. vs. Troika estimate		1.7	3.4	4.7	6.0	7.3

Source: Citi Investment Research and Analysis

**We expect the troika to extend the funding for Portugal soon**

We thus expect that there will be also an extension of the Troika funding at least through the end of 2014, and probably even up to the end of 2015. We estimate that the funding gap will increase by €25bn if it goes to the end of 2014 and by €65bn for an extension to 2015 (see Figure 9). Given the risks of supplementary funding being required for SOEs and PPPs, we estimate that an additional 4.7ppt of GDP would be provided for a program ending in 2014 and 7.3ppt of GDP for a program ending



**But are not expecting the Troika to agree to PSI for Portugal just yet**

**We look at the effect of various scenarios around the Troika base case**

**The Troika base case assumes a very optimistic outlook for Portugal's short- and long-term growth performance**

in 2016 (See Figure 10 above). These numbers assume that the first program did not make full provision for these liabilities and/or understated their actual cost.

We do not expect that a PSI will be included initially when the Troika agrees to extend the first program. Indeed, the statements that the Greek PSI is an exception and that such measures will not be repeated in other euro area countries are too recent. Furthermore, unless the Troika changes its outlook on the Portuguese economy significantly, the debt sustainability analysis will probably show a debt-to-GDP ratio around 120% in 2020, which by Greek standards is synonymous with debt sustainability.

## Assessing Portugal's debt dynamics

The factors mentioned above highlight the high degree of uncertainty regarding the outlook for Portuguese debt in the near-to medium term. Hence, we run several simulations based on the Troika's central case scenario to get a sense of the main vulnerabilities.

According to the Troika's central case scenario, Portuguese debt will increase from 107.2% of GDP in 2011 to 116.3 % of GDP in 2012 and peak at 118.1% in 2013. Debt sustainability is expected to be confirmed from 2014, when the debt-to GDP ratio is expected to decline to 115.8% The IMF estimates that the Portuguese debt-to-GDP ratio will fall to 113.5% of GDP in 2015 and to 102.7% of GDP by 2020.<sup>4</sup> The Troika assumes that Portuguese GDP falls by 3.0% in 2012 followed by a mild recovery (0.7%) in 2013 and a pick-up in growth to 2.4% in 2014. Thereafter, the Troika assumes real GDP growth of 2.0% per year and nominal GDP growth of 4%. As the Troika expects that Portugal will return to market funding in 2013, it estimates the average interest rate for new debt of around 4.8% for the period up to and including 2015.

**Figure 11. Portugal — Debt-to-GDP Levels in 2016**

Main scenarios for GDP and Yield assumptions					
GDP Growth	Minus 3ppt	Minus 1%	Troika	Plus 1%	Plus 3%
	152.9	110.7	111.3	112.5	115.6
Yields	Minus 300bp	Minus 100bp	Troika	Plus 200bp	Plus 700bp
	109.5	110.7	111.3	112.5	115.6

Source: Citi Investment Research and Analysis

**Figure 12. Portugal — Debt-to-GDP Levels in 2020**

Main scenarios for GDP and Yield assumptions					
GDP Growth	Minus 3ppt	Minus 1%	Troika	Plus 1%	Plus 3%
	202.3	134.3	102.9	72.9	16.6
Yields	Minus 300bp	Minus 100bp	Troika	Plus 200bp	Plus 700bp
	98.3	101.4	102.9	106.1	114.2

Source: Citi Investment Research and Analysis

**But growth is everything: get that wrong and unsustainability follows**

**First**, we examine a number of scenarios for GDP growth spanning the 2012-16 period around the Troika's baseline. In a scenario of GDP growth being 1ppt or 3ppt higher than the Troika central case — and everything else equal (including the fiscal tightening and interest rates) — the peak in the debt to GDP ratio will be reached in 2012, a year earlier than expected by the Troika. By 2015, the debt-to-GDP ratio would fall to 104% and 85%, respectively. However, in the event of GDP growth undershooting by 1ppt and 3ppt (the latter being the closest to our base scenario), the debt-to-GDP ratio would be on an unsustainable path, rising to 134% and 202% of GDP, respectively, in 2020.

<sup>4</sup> According to the Troika, the spikes in the debt ratio in 2011 and 2012 are due to the accumulation of reserves under the Programme's Bank Solvency Support Facility in case the government plays an active role in augmenting banks' capital.

**Yields matter but not by as much (at least not in a static environment)**

**Figure 13. Portugal — Contingent Liabilities Scenarios for Debt-to-GDP Ratio**

	Troika Baseline	+2.5 pa	+5.0 pa	+10 pa
2011	107.2	107.2	107.2	107.2
2012	116.2	118.7	121.2	126.2
2013	118.0	123.0	128.1	138.2
2014	115.8	123.4	131.0	146.2
2015	113.4	123.5	133.7	154.0
2016	111.3	121.6	131.8	152.3
2017	109.2	119.6	130.0	150.7
2018	107.2	117.6	128.1	149.0
2019	105.1	115.6	126.2	147.3
2020	102.9	113.6	124.3	145.6

Source: Citi Investment Research and Analysis

**We believe that Portugal's GDP performance will remain weak but that Portugal will benefit from low rates**

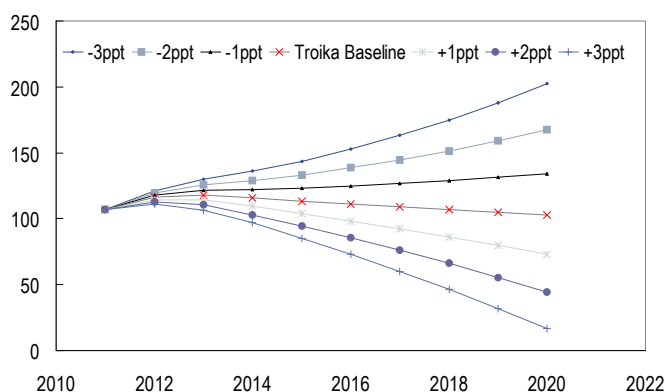
**Second**, we vary the level of interest rates from 2013 onwards, the year from which the Troika expects Portugal to return to the market. In this non-dynamic simulation (ignoring the impact of different interest rates on GDP), we simulate a more optimistic scenario, with interest rates for Portuguese new bond issuance being 300bp below the central Troika scenario (the spreads to Bunds being zero). In an adverse scenario, we set Portuguese funding cost at 700bp above the Troika central scenario (or 1,000 bp above Bunds). While in the benign scenario, the debt-to-GDP ratio falls to 98% in 2020, some 5ppt below the Troika's 103% baseline, in the adverse scenario the debt-to-GDP ratio would overshoot the baseline by 11ppt reaching 114% of GDP by 2020.

**Third**, we vary the expected cost of the contingent liabilities (PPPs, SOEs, Bank recaps) and the revenue that the government will get from privatizations. We find that with additional costs amounting to 2.5% of GDP p.a., Portugal's debt would peak in 2015 and around 123% of GDP; with additional costs per annum of 5% of GDP, the debt would peak at 133.7% and with additional costs of 10% of GDP per annum the debt would peak at 154% relative to the Troika baseline of 113.4%.

## We expect Portugal to be on an unsustainable fiscal path

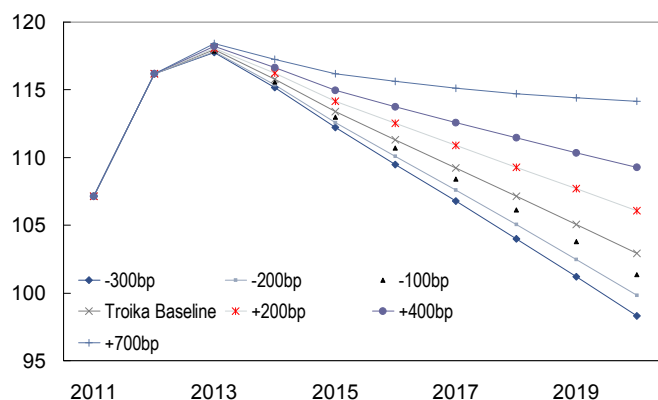
In our baseline scenario, we expect GDP to contract by 5.5% in 2012, 3.4% in 2013 and 0.4% in 2014. Thereafter we forecast weak GDP growth of around 1.3% from 2016 onwards. Since we believe that the initial Troika program will be extended, our assumption for funding costs of about 2.9% in the period between 2012 and 2016 is lower than the Troika's. We estimate that the government is able to implement around 80% of the already agreed austerity measures in 2012 and that the government makes extra transfers and subsidies to the PPPs and SOEs worth around 0.5% of GDP per year up to 2015, partly offsetting the austerity measures. In addition, we assume that capital injections to banks, SOEs and PPPs, mainly due to called-in guarantees, will be around 1.5% of GDP per year higher than those expected by the Troika, while privatization revenues will be around 0.5% of GDP lower than estimated by the Troika.

**Figure 14. Portugal — Impact of Different Growth Assumptions on Debt-to-GDP**



Source: Citi Investment Research and Analysis

**Figure 15. Portugal — Impact of Different Yield Assumptions on Debt-to-GDP**



Source: Citi Investment Research and Analysis



**Our low growth assumption drives the substantial increases in the debt to GDP ratio in the years to come**

In our baseline scenario, the debt-to-GDP ratio would continue to increase up to 2015/16 to around 146% of GDP, even with the low funding rates that would be part of a second Troika program. With such a level of debt, we argue that Portugal even in 2017 would probably not be able to return to markets and issue at affordable rates. However, with a PSI-style debt restructuring, probably enforced through the use of retrospective CACs, which as we have learned in the Greek case are unlikely to include the Eurosystem's SMP holdings, Portugal might get back on a sustainable fiscal path. If done in 2012, a 50% haircut (worth around €68bn) in the nominal value of government debt held by the private sector would help to cap the peak in the debt-to-GDP ratio at around 113% in 2015. Note that additional capital requirements for Portuguese banks (around €10bn) because of their losses on their sovereign holdings will partly offset the debt reduction.

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## Key Economic Indicators (27 February – 2 March 2012)

During The Week		Forecast	Last
07:00	UK: Nationwide House Prices, Feb		
<b>Monday 27 February</b>		<b>Forecast</b>	<b>Last</b>
07:45	France: Producer Prices, Jan	0.5% MM, 4.1% YY	-0.1% MM, 4.7% YY
09:00	Italy: Manufacturing Confidence, Feb		
09:00	Euro Area: M3, Jan	1.8% YY, 1.8% 3-M YY	1.6% YY, 1.9% 3-M YY
	German Parliament votes on 2 <sup>nd</sup> Greek Bailout		
<b>Tuesday 28 February</b>		<b>Forecast</b>	<b>Last</b>
	Germany: National CPI, Feb Preliminary	0.8% MM, 2.4% YY	-0.4% MM, 2.1% YY
	HICP, Feb Preliminary	0.8% MM, 2.5% YY	-0.5% MM, 2.3% YY
07:00	Germany: GfK Consumer Confidence, Mar		
08:15	Switzerland: Unemployment, 4Q		
08:30	Sweden: Retail Sales, Jan	0.6% MM	0.1% MM
10:00	Euro Area: Economic Confidence, Feb	93.0	93.4
	Industrial Confidence, Feb	-7.5	-7.2
	Consumer Confidence, Feb Final	-20.2	-21
11:00	UK: CBI Retail Survey, Feb		
11:00	Ireland: Retail Sales, Jan / Residential Property Price Index, Jan		
NA	Spain: Budget Balance, Jan		
<b>Wednesday 29 February</b>		<b>Forecast</b>	<b>Last</b>
00:01	UK: GfK Consumer Confidence, Feb		
07:00	Germany: Import Prices, Jan	0.6% MM, 2.9% YY	0.3% MM, 3.9% YY
07:45	France: Consumer Spending, Jan	-1.0% MM, -3.3% YY	-0.7% MM, -3.1% YY
08:00	Spain: HICP, Feb Flash Estimate		
08:00	Denmark: GDP, 4Q		
08:30	Sweden: GDP, 4Q	-1.0% QQ	1.6% QQ
08:55	Germany: Unemployment, Feb	+10K	-34K
09:00	Norway: Credit Growth Indicator C2, Jan	6.8% YY	6.7% YY
09:00	Norway: Regional Network Report, 4Q		
09:30	UK: Personal Borrowing, Jan		
10:00	Euro Area: HICP, Jan Final	-0.7% MM, 2.7% YY	0.3% MM, 2.7% YY
10:30	Switzerland: KOF Economic Barometer, Feb		
11:00	Ireland: Unemployment, Feb		
NA	Greece: Retail Sales, Dec		
<b>Thursday 1 March</b>		<b>Forecast</b>	<b>Last</b>
	European Summit of EU Heads of State and Government, Brussels (Mar 1-2)		
06:30	France: ILO Mainland Unemployment, 4Q	Rate: 9.5% Change: +70K	Rate: 9.3% Change: +37K
06:45	Switzerland: GDP, 4Q		
07:30	Sweden: PMI, Feb	51.6	51.4
08:00	Norway: PMI, Feb SA	54.4	54.9
08:30	Switzerland: PMI, Feb	47.2	47.4
09:00	Norway: Registered Unemployment Rate, Feb	2.7%	2.8%
09:00	Italy: Unemployment, Jan		
09:00	Euro Area: Manufacturing PMI, Feb Final	49.0	48.7
09:30	UK: Manufacturing PMI, Feb	51.1	52.1
10:00	Italy: Consumer Prices, Feb Preliminary		
10:00	Euro Area: HICP, Feb Flash Estimate	2.7% YY	2.7% YY
10:00	Euro Area: Unemployment Rate, Jan	10.5%	10.4%
18:00	Italy: Budget Balance, Feb		
<b>Friday 2 March</b>		<b>Forecast</b>	<b>Last</b>
07:00	Germany: Retail Sales, Jan	0.7% MM	0.1% MM
08:00	Spain: Unemployment, Feb		
09:00	Norway: Retail Sales, Jan	-2.6% MM, 1.8% YY	-0.3% MM, 2.6% YY
10:00	Italy: GDP and Debt, 2011		
10:00	Euro Area: Industrial Producer Prices, Jan	0.3% MM, 3.3% YY	-0.2% MM, 4.3% YY
16:30	Ireland: Exchequer Statement, Feb		
<b>Sunday 4 March</b>		<b>Forecast</b>	<b>Last</b>
	Russia: Presidential Election		

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

## Economic Indicators

### Euro Area

Feb 27 09:00 London Time	<b>M3, Jan</b>	<b>Forecast: 1.8% YY, 1.8% 3-M YY</b>	<b>Prior: 1.6% YY, 1.9% 3-M YY</b>
	Following the drop in M3 growth in December that might have been somewhat overstated by year-end effects, we expect a small rebound in M3 growth, which is partly due to base effects. After the 0.6% MM fall in new loans transaction in December, we expect a smaller decline of around 0.2% MM in January.		
Feb 28 10:00 London Time	<b>Economic Confidence, Feb</b>	<b>Forecast: 93.0</b>	<b>Prior: 93.4</b>
	<b>Industrial Confidence, Feb</b>	<b>Forecast: -7.5</b>	<b>Prior: -7.2</b>
	<b>Consumer Confidence, Feb Final</b>	<b>Forecast: -20.2</b>	<b>Prior: -20.7</b>
	After stabilizing in January, which might have been upwardly distorted by unusually mild winter weather in that month, we expect economic confidence to deteriorate again in February, when unusually cold winter weather probably had some negative impact on the sentiment reading.		
Feb 29 10:00 London Time	<b>HICP, Jan Final</b>	<b>Forecast: -0.7% MM, 2.7% YY</b>	<b>Prior: 0.3% MM, 2.7% YY</b>
	We expect a confirmation of the flash estimate for January. The split probably will show an increase in the core inflation rate (mainly amid indirect tax increases) from 1.6%YY in December to 1.8% YY in January. But, mainly due to base effects, energy price gains are likely to moderate from 9.7% YY in December to 7.8% YY in January.		
Mar 1 09:00 London Time	<b>Manufacturing PMI, Feb Final</b>	<b>Forecast: 49.0</b>	<b>Prior: 48.7</b>
	We expect a confirmation of the flash estimate.		
Mar 1 10:00 London Time	<b>HICP, Feb Flash Estimate</b>	<b>Forecast: 2.7% YY</b>	<b>Prior: 2.7% YY</b>
	Despite benign base effects, we expect inflation to be unchanged in February. Increasing oil prices and unusually cold weather probably prevented a decline in inflation in February.		
Mar 1 10:00 London Time	<b>Unemployment Rate, Jan</b>	<b>Forecast: 10.5%</b>	<b>Prior: 10.4%</b>
	While unusually mild weather in northern Europe probably distorted January unemployment temporarily on the downside, we expect that ongoing job losses in the periphery countries contributed to an increase in the unemployment ratio.		
Mar 2 10:00 London Time	<b>Industrial Producer Prices, Jan</b>	<b>Forecast: 0.3% MM, 3.3% YY</b>	<b>Prior: -0.2% MM, 4.3% YY</b>
	The ongoing decline in the YY rate reflects benign base effects, which are mainly due to large swings in commodity prices.		
<b>Germany</b>			
Feb 28	<b>National CPI, Feb Preliminary</b>	<b>Forecast: +0.8% MM, 2.4% YY</b>	<b>Prior: -0.4% MM, 2.1% YY</b>
	<b>HICP, Feb Preliminary</b>	<b>Forecast: +0.8% MM, 2.5% YY</b>	<b>Prior: -0.5% MM, 2.3% YY</b>
	The rise in the monthly and annual rate is partly due to rising energy prices, reflecting the increase in crude oil prices and the unusually cold weather conditions. We also expect a somewhat larger than usual increase in prices for clothing after the end of the sales period.		
Feb 29 07:00 London Time	<b>Import Prices, Jan</b>	<b>Forecast: 0.6% MM, 2.9% YY</b>	<b>Prior: 0.3% MM, 3.9% YY</b>
	Higher prices for oil and other commodities probably contributed to an increase in import prices in January. Furthermore, the weakening of the EUR in 2H 2011 probably made a small contribution to the gain. However, with benign base effects, the YY rate is likely to continue to fall to 2.9% in January, the lowest reading since February 2010.		
Feb 29 08:55 London Time	<b>Unemployment, Feb</b>	<b>Forecast: +10K</b>	<b>Prior: -34K</b>
	Following a larger than expected fall in unemployment in January, which was probably partly due to unusually mild weather, we expect an increase in unemployment in February, mainly as a technical correction of the January reading. The seasonal unemployment ratio is likely to stay at the historical low for Germany after unification of 6.7%.		
Mar 2 07:00 London Time	<b>Retail Sales, Jan</b>	<b>Forecast: 0.7% MM</b>	<b>Prior: 0.1% MM</b>
	After the hefty revision of the December figures from -1.4% MM to +0.1% MM, we expect a decent start for retail sales in 2012. Improving consumer sentiment and willingness to purchase readings support our forecast.		
<b>France</b>			
Feb 27 07:45 London Time	<b>Producer Prices, Jan</b>	<b>Forecast: 0.5% MM, 4.1% YY</b>	<b>Prior: -0.1% MM, 4.7% YY</b>
	Although producer prices are expected to have risen in January, reflecting higher commodity and energy prices, various surveys also suggest that firms have been increasing their factory gate prices in response to a slight pick-up in activity in the last few months of 2011. Large base effects are expected to come into play, driving the headline YY rate down to its lowest level since November 2010.		
Feb 29 07:45 London Time	<b>Consumer Spending, Jan</b>	<b>Forecast: -1.0% MM, -3.3% YY</b>	<b>Prior: -0.7% MM, -3.1% YY</b>
	Car sales plunged by nearly 20% MM in January, and the weather was warmer than the seasonal norm, suggesting that both of the more volatile components of consumer spending will have contributed negatively. Although retail sales rose according to the Banque de France and household confidence bounced back a little, we forecast a second successive monthly decline in household expenditure.		
Mar 1 07:45 London Time	<b>ILO Mainland Unemployment Rate, 4Q</b>	<b>Forecast: 9.5%</b>	<b>Prior: 9.3%</b>
	<b>Mainland Unemployment Change (000s)</b>	<b>Forecast: +70K</b>	<b>Prior: +37K</b>
	The quarterly increase in the total number of registered unemployed rose by almost 50% in the fourth quarter according to the monthly data. We estimate that on the ILO basis the increase was slightly more pronounced. At the same time, participation in the labour force could have diminished again, pointing to an increase of at least 0.2pt in the mainland jobless rate. President Sarkozy's poor record with unemployment during this five-year term (+1.5ppt) will be one of many obstacles to his re-election.		

## Economic Indicators

Sweden			
Feb 28 08:30	Retail Sales, Jan SA	Forecast: 0.6% MM	Prior: 0.1% MM
London Time	Sentiment indicators remain weak, although we have seen improvement (in particular in January) in recent months. According to the NIER consumer confidence survey, we have seen a marked improvement in durable goods trade, which now stands only slightly below the long-term average (both current and expected trade).		
Feb 29 08:30	GDP, 4Q	Forecast: -1.0% QQ	Prior: 1.6% QQ
London Time	Lower industrial production and, in particular, the surprisingly large drop in exports point to a marked GDP growth slowdown in the final quarter of 2011. Our model points to a 1% QQ contraction, well below the Riksbank's revised forecast from the February Monetary Policy Report of -0.4% QQ. The expected decline in 4Q GDP is larger than implied by sentiment indicators and is partly a reaction to the very strong growth in 3Q.		
Mar 1 07:30	PMI, Feb	Forecast: 51.6	Prior: 51.4
London Time	In January, the PMI rose by a stronger-than-anticipated 2.5 points to 51.4, reflecting a 5.0 points jump in the orders component to 52 and a 3.7 points rise in the production index to 52.9. Given the improvement in the euro-area manufacturing PMI in February, we expect the Swedish PMI to creep higher, and stay above 50. A rise, though, clearly is at odds with the recent deteriorating trend in manufacturing sentiment according to the NIER survey. Both Swedish PMI and NIER survey data remain above the levels assumed in our GDP forecast for 2012. With a Swedish export share of 40% to the euro area and 70% to all of Europe, sentiment is likely to decline ahead.		
Norway			
Feb 29 09:00	Credit Indicator Growth C2, Jan	Forecast: 6.8% YY	Prior: 6.7% YY
London Time	The latest lending survey from the Norges Bank showed that during 1Q 2012, banks expect credit standards on household loans to tighten further, while those for the corporate sector are seen as stable. With regard to loan demand, banks expect corporate loan demand to moderate further in 1Q, while that from households likely will remain unchanged. On balance, we expect credit to households to stay in the area of 7.2%-7.3% YY, while credit to non-financial enterprises remains broadly unchanged at 5.3% YY.		
Feb 29 09:00	Regional Network Report		
London Time	The 4Q 2011 Regional Network Report showed that growth had already moderated somewhat with respondents expecting further slowing in the first quarter of 2012. Momentum, though, remained healthy and albeit further moderation was expected, in particular due to a deteriorating outlook for the export sector, an abrupt slowdown was not expected. Said differently, output expectations in the 4Q 2011 Regional Network Report were in line with marginally below-trend growth in mainland GDP (excluding oil/gas and shipping). We expect output expectations to have moderated further in the 1Q 2012 report.		
Mar 1 09:00	PMI, Feb SA	Forecast: 54.4	Prior: 54.9
London Time	Norwegian PMI surprisingly recovered in January, jumping 8.3 points to 54.9. The gain was primarily led by a 17.9 points jump in the orders index to 57.9, but a 7.4 points rise in the employment index and a 4.8 points gain in the production component also supported the rise. We expect the Norwegian PMI to remain broadly stable in February – while the euro area PMI rose marginally, the German PMI deteriorated slightly. The rebound in the order index supports a further rise in the overall index ahead, but the strong reading in January could also be seen as pay back from very weak levels in previous months.		
Mar 1 09:00	Registered Unemployment Rate, Feb	Forecast: 2.7%	Prior: 2.8%
London Time	Registered unemployment is seen improving marginally to 2.7% in February.		
Mar 2 09:00	Retail Sales, Jan SA	Forecast: -2.6% MM; 1.8% YY	Prior: -0.3% MM; 2.6% YY
London Time	Retail sales picked up in the last quarter of the year, rising 0.8% QQ in 4Q versus a 0.4% QQ gain in 3Q. This is still marginally below the long-term average and the latest development in consumer confidence points to a further slowdown in private consumption ahead.		
Switzerland			
Feb 29 10:30	KOF Economic Barometer, Feb	Forecast: -0.35	Prior: -0.17
London Time	The Kof index has weakened for eight consecutive months, and currently is at the lowest since July 2009. We expect another modest decline this month, reflecting the drag from the strong CHF and EMU weakness, leaving the index at a level consistent with recession.		
Mar 1 06:45	GDP, 4Q	Forecast: 0.1% QQ, 1.2% YY	Prior: 0.2% QQ, 1.5% YY
London Time	Weakness in the KOF and PMI surveys in recent months suggest that the Swiss economy is softening markedly. It is uncertain in our view as to whether GDP already started to fall in 4Q or whether the decline starts in 1Q, but some negative GDP figures are likely. .		
Mar 1 08:30	PMI, Feb	Forecast: 47.2	Prior: 47.4
London Time	The PMI has been below 50 for five months in a row, signaling renewed contraction in the manufacturing sector. We expect another weak reading this month, which would suggest that the economy is shrinking in 1Q.		
United Kingdom			
Mar 1 09:30	Manufacturing PMI, Feb	Forecast: 51.1	Prior: 52.1
London Time	The manufacturing PMI has risen for three months in a row but we anticipate a slight pullback this month. The UK's main export markets in the euro area are weak, and investment in the UK is likely to be weak given the drop in capacity use and uncertain outlook.		

Sources: National Statistical Offices, National Central Banks, Bloomberg, CIRA forecasts

## Economic Indicators

### Key Economic Indicators (5 March – 9 March 2012)

During The Week		Forecast	Last
07:00	Germany: Insolvencies, Dec		
09:00	UK: Halifax House Prices, Feb		
Monday 5 March		Forecast	Last
08:15	Switzerland: Retail Sales, Jan		
08:30	Sweden: Services Production, Jan		
09:00	Italy: Producer Prices, Jan		
09:00	Euro Area: Services PMI, Feb Final		
	Composite PMI, Feb Final		
09:30	UK: Services PMI, Feb	55.0	56.0
10:00	Euro Area: Retail Sales, Jan		
Tuesday 6 March		Forecast	Last
10:00	Euro Area: GDP Details, 4Q		
Wednesday 7 March		Forecast	Last
06:45	Switzerland: Unemployment, Feb		
08:00	Switzerland: Reserves, Feb		
08:00	Spain: Industrial Production, Jan		
09:00	Norway: Industrial Production, Jan		
11:00	Germany: Incoming Orders, Jan		
14:00	Belgium: GDP, 4Q Final		
Thursday 8 March		Forecast	Last
06:30	France: Nonfarm Payrolls, 4Q Final		
08:15	Switzerland: Consumer Prices, Feb		
08:30	Netherlands: Consumer Prices, Feb		
	Greece: Unemployment Rate, Dec		
11:00	Germany: Industrial Production, Jan		
12:00	UK: MPC Meeting Outcome		
12:45	Euro Area: ECB Meeting Outcome – Press Conference at 13:30		
	Greek Bond Swap Offer: Last day to sign up		
Friday 9 March		Forecast	Last
07:00	Germany: Labour Cost Index, 4Q		
07:00	Germany: Trade Balance, Jan		
07:00	Germany: Consumer Prices, Feb Final		
07:45	France: Industrial Production, Jan		
08:00	Spain: Retail Sales, Jan		
08:30	Sweden: Industrial Production, Jan		
09:00	Norway: Consumer Prices, Feb		
09:00	Italy: Industrial Production, Jan		
09:30	UK: Industrial Production, Jan	-0.5% MM, -3.6% YY	0.5% MM, -3.3% YY
	Manufacturing Output, Jan	-0.6% MM, -0.7% YY	1.0% MM, 0.8% YY
09:30	UK: Producer Prices, Feb		
09:30	UK: BoE/GfK NOP Inflation Attitudes Survey, Feb		
11:00	Portugal: GDP, 4Q		
	Greece: GDP, 4Q Final		
	Greece: Consumer Prices, Feb		
Sunday 10 March		Forecast	Last
	Slovakia: General Election		

Sources: National statistical offices, central banks and Citi Investment Research and Analysis

Recent Research Publications	Author	Date of Publication
<b>Euro Area</b>		
<a href="#">Euro Area: Sovereign Debt Crisis Update -</a>	Guillaume Menuet	Feb 24, 2012
<a href="#">European Economic Forecast Highlights - February, 2012</a>	Ann O'Kelly	Feb 23, 2012
<a href="#">ECB Involvement in Greek Debt Restructuring</a>	Jürgen Michels	Feb 14, 2012
<a href="#">ECB - No Immediate Rate Cut, Modest Expansion of Eligible Collateral</a>	Jürgen Michels	Feb 9, 2012
<b>Euro Weekly</b>		
<a href="#">Euro Weekly - Ireland — Tough Times Ahead</a>	Michael Saunders	Feb 17, 2012
<a href="#">Rising Risk of Greek Euro Area Exit</a>	Jürgen Michels	Feb 10, 2012
<a href="#">ECB - Watch Out For the Details</a>	Jürgen Michels	Feb 3, 2012
<b>Switzerland</b>		
<a href="#">Switzerland - The OECD Warn Of Drag on Growth from Strong CHF and EMU Crisis</a>	Michael Saunders	Jan 27, 2012
<b>Global</b>		
<a href="#">Global Economic Outlook and Strategy - February 2012</a>	Willem Buiter	Feb 22, 2012
<a href="#">Sovereign Ratings Outlook - January 2012</a>	Michael Saunders	Jan 18, 2012
<b>Norway</b>		
<a href="#">Scandi / Swiss Update</a>	Tina Mortensen	Feb 24, 2012
<a href="#">Norway - Annual Address: No Policy Signals, Balanced Tone</a>	Tina Mortensen	Feb 17, 2012
<a href="#">Norway - 4Q Mainland GDP Beats Expectations</a>	Tina Mortensen	Feb 16, 2012
<b>Sweden</b>		
<a href="#">Sweden - 25bp Rate Cut to 1.50%, No Signals of Additional Easing</a>	Tina Mortensen	Feb 16, 2012
<a href="#">Sweden - February Rate Cut Likely, But No Certainty</a>	Tina Mortensen	Feb 13, 2012
<a href="#">Sweden - PMI Weakens Again</a>	Tina Mortensen	Feb 1, 2012
<b>UK</b>		
<a href="#">UK – GDP Data Highlight Investment Weakness</a>	Michael Saunders	Feb 24, 2012
<a href="#">UK – Split MPC Vote, Gloomy Agents</a>	Michael Saunders	Feb 22, 2012
<a href="#">UK – Fiscal Deficit Likely to Undershoot</a>	Michael Saunders	Feb 21, 2012
<a href="#">UK – BoE Inflation Report</a>	Michael Saunders	Feb 15, 2012
<a href="#">UK – CPI Inflation Continues to Tumble</a>	Michael Saunders	Feb 14, 2012
<a href="#">UK – Moody's Put UK on Negative Outlook</a>	Michael Saunders	Feb 14, 2012
<a href="#">UK - £50bn More QE</a>	Michael Saunders	Feb 9, 2012
<b>Sterling Weekly</b>		
<a href="#">Sterling Weekly - Where Will the Growth Come From?</a>	Michael Saunders	Feb 17, 2012
<a href="#">Sterling Weekly - Dovish Inflation Report Expected</a>	Michael Saunders	Feb 10, 2012
<a href="#">We Forecast Another £75bn QE</a>	Michael Saunders	Feb 3, 2012

Source: Citi Investment Research And Analysis



## **Notes**

## **Notes**

## Appendix A-1

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