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Research Update:

Republic of Portugal Ratings Lowered To 'A-/A-2' On Weak Macroeconomic Structure; Outlook Negative

Primary Credit Analyst:

Kai Stukenbrock, Frankfurt (49) 69-33-999-247;kai_stukenbrock@standardandpoors.com

Secondary Credit Analyst:

Trevor Cullinan, London (44) 20-7176-7110;trevor_cullinan@standardandpoors.com

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Overview

- Fiscal and economic structural weaknesses in our view leave the Republic of Portugal in a comparably weak position to address the significant deterioration in its public finances and expected lackluster economic growth prospects over the medium term.
- We are lowering our long-term ratings on Portugal to 'A-' from 'A+' and the short-term ratings to 'A-2' from 'A-1'.
- The negative outlook reflects our assessment of the risk of a further downgrade should fiscal consolidation fall short of expectations or should concerns over government liquidity mount.

Rating Action

On April 27, 2010, Standard & Poor's Ratings Services lowered its long-term local and foreign currency sovereign issuer credit ratings on the Republic of Portugal to 'A-' from 'A+'. At the same time the local and foreign currency short-term ratings were lowered to 'A-2' from 'A-1'. The outlook is negative. The 'AAA' transfer and convertibility assessment is unchanged.

Rationale

The two-notch downgrade reflects our view of the amplified fiscal risks Portugal faces. Under our revised base case economic growth scenario, we expect the Portuguese government could struggle to stabilize its relatively high debt ratio over the outlook horizon until 2013. Portugal's public finances in our view remain structurally weak, notwithstanding the government's substantial public sector reforms of recent years.

We believe past dependence on now more scarce external financing as a source of economic growth, and weak external competitiveness add to the likely adverse growth dynamics in Portugal. As a result, to reach its current targets we expect that the Portuguese government would need to implement fiscal consolidation over and above its current plans. Portugal's fiscal indicators, as well as its growth outlook, in our view compare unfavorably with the 'A' median for sovereigns.

We have revised downward our growth scenario for Portugal and now expect economic activity to stagnate in 2010, after a contraction of 2.7% in 2009. In our opinion, the economy's growth potential will likely remain subdued,

constrained by weak international competitiveness, low productivity gains, stagnating investment growth, and falling domestic credit as the highly leveraged private sector reduces debt. Domestic credit, at 172% of GDP in 2009, is comparatively high in Portugal compared with that of most other Eurozone members.

We also consider it likely that relatively rigid product and labor markets could impede growth prospects in Portugal, prolonging the adjustment in prices and wages we view as necessary to regain external competitiveness. As a result, we expect real GDP growth to return to 1% only by 2012. Moreover, in our opinion the increase in nominal GDP is likely to be restricted by our expectation of low average GDP deflator growth of 0.6% over 2010-2013. This, in turn, is likely to lead in our opinion to higher deficits and debt ratios.

An increase in the structural general government deficit alongside a cyclical decline in economic output has in our view caused Portugal's public finances to worsen significantly, reversing previous progress in fiscal consolidation since 2005. The government deficit rose to 9.4% of GDP in 2009 from 2.7% in 2008. The government initially chose to implement only limited consolidation measures in 2010, which is why we expect the deficit to remain high, at 8.5% of GDP in 2010. However, we understand that the government is now considering accelerating some consolidation efforts to 2010 that were initially intended for 2011. Nevertheless, the overall consolidation effort remains unchanged. The government has announced that it aims to cut the deficit to less than 3% of GDP by 2013.

We expect fiscal consolidation to progress at a slower pace than the government foresees, achieving a deficit of 4.1% of GDP by 2013. This is because we believe that there is implementation risk with regard to the government's announced program, particularly given that the minority government will need opposition support to pass necessary legislation. Still, our base-case assumption remains that the government should be able to form ad hoc alliances to secure direct or indirect support for key legislation, as it did during the parliamentary vote on the convergence program on March 25, 2010. We also regard the government's growth assumptions as optimistic, in our view overstating the fiscal impact of cyclical recovery. The government could, however, raise taxes, which are currently not part of the consolidation plan, should the decrease in deficits not be as swift as envisaged. This option, which is not currently part of our base-case scenario for public finances, provides upside potential to our forecast numbers.

In line with our expectation of high deficits and weak economic growth, we expect government debt to continue to rise rapidly, to 95% of GDP by 2013 from 66% in 2008. Portugal has one of the highest debt-rollover ratios in the Eurozone, at almost 18% of GDP in 2010. Fiscal imbalances and high debt rollover in our opinion leave Portugal vulnerable to changes in investor sentiment. The resulting interest rate shock or further shocks to economic growth could in our view lead to a significantly more pronounced increase in the government's debt ratio. We believe this could eventually increase the pressure for faster and more pronounced fiscal adjustment.

Outlook

The negative outlook on Portugal reflects our assessment of the potential for a further downgrade if deficits and debt levels exceed our current expectations and if consolidation measures are not fully implemented. Meanwhile, sustained weak growth in nominal GDP could in our view also undermine the government's efforts to improve the general government deficit and debt ratios. Downward pressure on the ratings could also result from adverse interest rate shocks to government finances.

We could revise the outlook to stable should the government manage to achieve at least its baseline consolidation agenda and put the budget deficit on a credible and sustainable downward path, thereby establishing a clear perspective for stabilizing and eventually reversing the debt ratio.

Related Criteria And Research

- Sovereign Credit Ratings: A Primer, May 29, 2008
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Lowered

	To	From
Portugal (Republic of)		
Sovereign Credit Rating	A-/Negative/A-2	A+/Negative/A-1
Senior Unsecured	A-	A+
Short-Term Debt	A-2	A-1
Commercial Paper	A-2	A-1
Transfer & Convertibility Assessment	AAA	AAA

NB: This list does not include all the ratings affected.

Additional Contact:

Sovereign Ratings;SovereignLondon@standardandpoors.com

Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4011.

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