How will the State be financed in 2019?

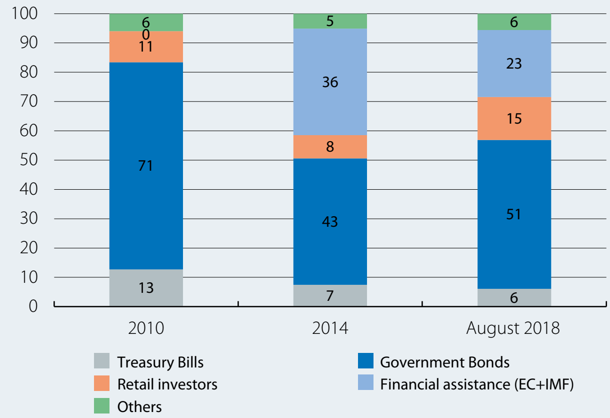
The gross funding required by the State every year includes, in a simplified manner, the amount of the general government deficit (the difference between revenues and expenditure) and the debt that is due to reach maturity each year.[1] Since 2015, the first full year following the end of Portugal's financial assistance programme, the State has been steadily decreasing its gross funding needs. It has achieved this through an effort to consolidate its budgets, which is evident in the reduction of the deficit, and through actively managing the maturity dates and the composition of the State's direct debt. For example, Portugal has swapped short-term debt (repurchased by the Treasury) for long-term debt (issued by the Treasury), it has issued more debt to the general public and it has made early repayments on its IMF loans during the financial assistance programme (83% of the IMF loan has already been repaid). In fact, this management has allowed Portugal to decrease its funding needs by almost 10 billion euros between 2015 and 2018 (almost 20% of the gross funding needs of 2015).

For the most part, the funding needs have been met through the issuance of short-term debt (Treasury Bills, or TBs) and long-term debt (Government Bonds, or GBs), with a fixed interest rate, which is acquired by both national and international institutional investors. In recent years, the Treasury has taken advantage of the low interest rate environment fostered by the ECB's unconventional monetary policy to extend the average maturity of its debt (which mitigates the risk of refinancing) and, at the same time, to reduce the cost of debt financing. In fact, between 2012 and 2017, the average maturity term of the debt rose from 6.9 to 8.1 years, while the cost of financing fell from 3.9% to 3.0%. The Treasury has also recently developed a strategy of diversifying its funding sources, which has led to an increase in the debt purchased by individual savers resident in Portugal, and it has favoured a broader and more stable investor base. At the same time, the Treasury has maintained a significant liquidity buffer (approximately 10 billion euros in recent years), which has allowed for a certain flexibility in the management of the annual funding programme.

In this context, in 2019, the State expects to stabilise its gross funding needs at around 37 billion euros, maintaining a similar funding strategy: issuing debt in the retail market (11%) and among institutional investors, both domestic and foreign. With regards to these debt

1. The State's net funding requirements and the repayments made during the year. The net requirements are made up of the budget deficit and the net acquisitions of assets, a category which includes the funding needs of public companies, allocations for the Resolution Fund and any bank restructuring costs that are not included in the deficit, among others.

Portugal: composition of State debt
(% of the total)



Source: *CaixaBank Research, based on data from the IGCP.*

issuances, the Government aims to issue 17.5 billion in Treasury Bonds, in an environment that will be marked by the end of the ECB's net purchases of assets. This could influence Portugal's cost of financing,[2] although the increase is expected to be relatively moderate. There are several factors that suggest this will be the case, including the fact that the ECB will continue to be present in the markets for a long time, buying assets in order to keep the size of its balance sheet stable (it will reinvest the principal of the bonds as they reach maturity). According to the Bank of Portugal,[3] these reinvestments will ensure that the ECB continues to absorb part of the duration risk[4] (which otherwise would have to be borne by private investors), and this will continue to exert persistent downward pressure on the longer maturities.

Of the total portfolio of public debt of the countries of the euro area that the ECB has acquired within its asset purchase programmes, 116.8 billion euros will reach maturity in 2019 (approximately 54% of the purchases of public debt that the ECB will have carried out during 2018).[5] This confirms that the Eurosystem will continue to have a significant presence in the bond market. While the

2. Moody's estimate, which suggests that the PSPP reduced the interest rate on Portuguese 10-year public debt by 140 bps, reflects the fact that the ECB's policies have had a significant impact on Portugal's financing costs (see «Moody's: Impact of ECB stimulus on 10-year bond yields is biggest for euro area periphery», December 2017).
3. Economic Bulletin (2018), «Euro area monetary policy: recent decisions and future prospects», October.
4. Duration risk refers to the risk premium demanded by investors for exposure to securities with a longer maturity.
5. Up until September, purchases reached 186.9 billion euros (2018 year to date). With the reduction in monthly purchases of 15 billion euros in the last quarter of the year, it is estimated that the purchases of public debt carried out by the ECB in 2018 will have a total value of approximately 218 billion euros.

ECB is not expected to buy Portuguese bonds as part of these reinvestments,[6] reinvesting in other countries' debt will indirectly benefit the interest rate of Portuguese debt, insofar as it will limit the supply of public debt available for purchase by private investors and, therefore, it will keep bond prices high (and interest rates at contained levels). In addition, specifically in the case of Portugal, a significant part of its debt securities acquired by the ECB as part of the SMP[7] will reach maturity during 2019, which would open up the possibility for the ECB to reinvest these Portuguese debt maturities.[8]

In addition to the favourable effect on the financing costs associated with the ECB's reinvestment policy, there are other factors that suggest that Portugal will continue to benefit from relatively low financing costs:

i) All the credit rating agencies currently assign Portugal's sovereign debt an investment grade credit rating.

ii) Foreign private investors account for a relatively small proportion of investors in Portuguese public debt. Specifically, the debt held by private non-residents represents only 13% of the total (these types of investors tend to be more proactive in managing their portfolios and can make disinvestment decisions more readily); official non-resident investors (ECB and loans of the Financial and Economic Assistance Programme, or FEAP) possess 39% of the debt.

iii) Among residents, debt placed in the retail market, which provides a more stable investor base, has grown as a proportion of the total (it currently accounts for approximately 15%).

iv) The average maturity of debt is relatively high (8 years).

v) A comfortable liquidity buffer has been maintained (9.5 billion in 2019, approximately half of the estimated requirements for 2019).

vi) There is continuity in the budgetary consolidation effort and a good rate of growth in the economy.

Portugal: State funding needs
(EUR billions)

	2015	2016	2017	2018	2019
1. Net funding needs	**11.8**	**8.3**	**10.4**	**8.5**	**8.6**
Budget deficit	5.6	6.2	4.8	3.1	3.6
Other acquisitions of financial assets	6.2	2.1	5.6	5.4	5.0
2. Repayments	**35.6**	**29.2**	**33.4**	**28.5**	**28.6**
Treasury Bills	18.3	15.0	15.5	15.5	14.1
Government Bonds + special medium-term bonds	8.8	9.7	7.9	8.5	10.5
Treasury and savings certificates	–	–	–	1.7	4.0
FEAP, repayments made *	8.4	4.5	10.0	0.8	–
*FEAP, repayments yet to be made **	–	–	–	*2.0*	*0.0*
3. Use of deposits	**5.8**	**–3.6**	**0.4**	**–0.4**	**0.8**
4. Funding sources (incl. use of deposits)	**45.9**	**37.6**	**45.7**	**35.3**	**37.5**
Treasury and savings certificates	3.5	3.5	2.8	2.7	3.0
Variable-yield Government Bonds	–	3.5	3.5	1.0	1.0
Treasury Bills	16.4	15.1	17.8	14.1	15.2
Government Bonds	20.2	17.4	15.1	17.4	17.5
Other flows (net)	–	1.7	6.1	0.5	–
Gross funding needs (1+2)	**47.4**	**37.5**	**43.7**	**37.0**	**37.2**
% of GDP	0.3	0.2	0.2	0.2	0.2
Availability of deposits at the year end	6.6	10.2	9.8	10.2	9.5

Note: ** FEAP is the financial and economic assistance programme (EC+IMF).*
Source: *CaixaBank Research, based on data from the IGCP and the 2019 State Budgets.*

6. Within the public sector purchase programme (PSPP), the ECB only has Portuguese public debt on its balance sheet that reaches maturity starting in 2020.
7. Securities Markets Programme, an ECB public debt purchase programme in secondary markets, which was in place between 2010 and 2012. According to the ECB's financial statements for 2017, the nominal value of Portuguese public debt securities amounted to 7.3 billion and had an average maturity of 2.3 years.
8. Nevertheless, the ECB has not yet finalised the details regarding the strategy for reinvesting the maturities, nor has it determined whether this strategy will only affect the assets of the PSPP or whether it could encompass assets purchased in other programmes as well.