

A Liability Management Proposal for the Republic of Portugal

Citigroup Team Page [pls update]

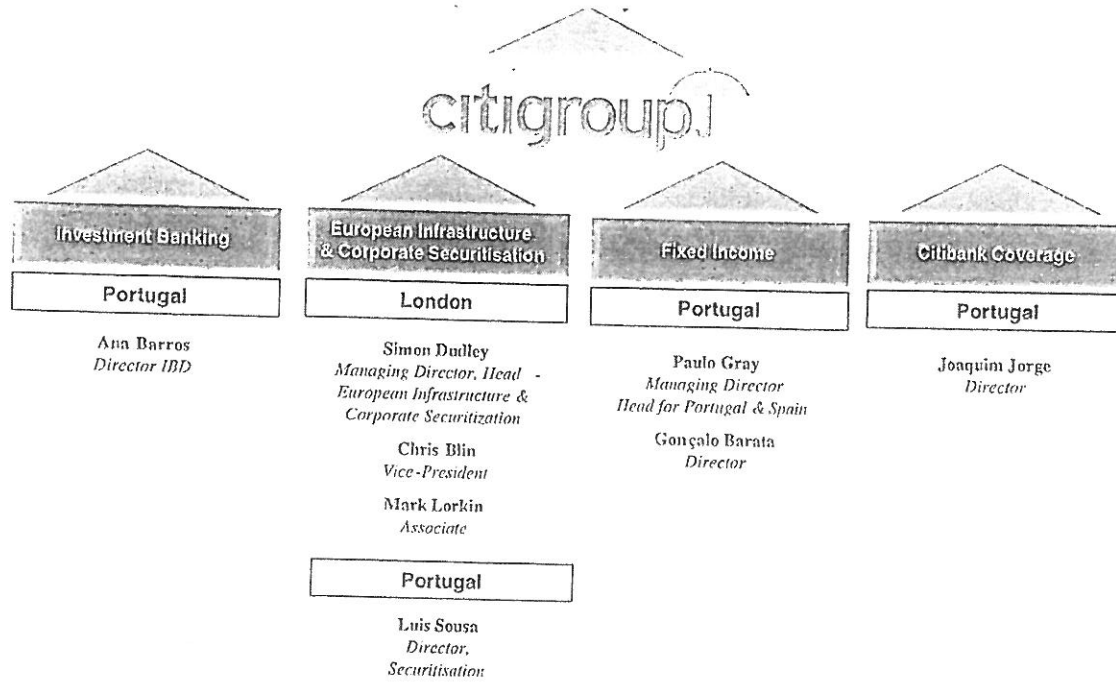


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THIS PRESENTATION FOCUSES ON INTEREST RATE DERIVATIVE AND LIABILITY MANAGEMENT STRATEGIES TO MINIMIZE INTEREST EXPENSE AND DEBT IN THE CURRENT INTEREST RATE ENVIRONMENT

Interest rate derivative products may allow the Republic of Portugal to achieve the following objectives

- Hedge its downside exposure to rising interest rates, minimizing its cost
- Provide a more cost effective alternative to bond financings in managing duration
- Manage the interest rate budget over the economic cycle
- Smooth refunding of maturing debt over the financial year
- Generate substantial cost benefits versus future cost of funds
- Minimize the impact of large new issuance on market pricing

DERIVATIVE INSTRUMENTS ENABLE DEBT MANAGEMENT AGENCIES TO ACHIEVE A BROAD RANGE OF OBJECTIVES

- Hedge or realize value from interest rate and currency markets
- Manage duration exposure to their 'benchmark' targets
- Enhance the cost benefits on their outstanding portfolio
- Manage repayment profiles, exchange & buy back programs

The greater acceptance of derivatives is based on sovereign clients' awareness that interest rate derivatives can provide

- Attractive economics (e.g. debt service costs reduction)
- Smoothing of outstanding portfolio events
- Efficient budget planning and management of fiscal budgets by the Ministry

Securities Listed on MEDIP/MTS Portugal

OUTSTANDING OT ISSUES

Security	ISIN Code	Type of rate	Status	Outstanding (EUR m)
OT 5.25% Oct 2005	PTOTEIOE0007	Fixed rate	Benchmark	5,138
OT 9.5% Feb 2006	PTOTEVOE0000	Fixed rate	Regular	831
OT 3% Jul 2006	PTOTEWOE0009	Fixed rate	Benchmark	5,072
OT 6.625% Feb 2007	PTOTEFOE0000	Fixed rate	Regular	2,110
OT 4.875% Aug 2007	PTOTEXOE0016	Fixed rate	Benchmark	5,117
OT 5.375% Jun 2008	PTOTEBOE0012	Fixed rate	Liquid	2,592
OT 3.25% July 2008	PTOTE20E0000	Fixed Rate	Benchmark	6,000
OT 3.95% Jul 2009	PTOTECOIE0011	Fixed rate	Benchmark	5,000
OT 5.85% May 2010	PTOTEHOE0008	Fixed rate	Benchmark	5,147
OT 5.15% Jun 2011	PTOTEJOE0006	Fixed rate	Benchmark	5,258
OT 5% Jun 2012	PTOTEKOE0003	Fixed rate	Benchmark	5,036
OT 5.45% Sep 2013	PTOTEGOE0009	Fixed rate	Benchmark	5,043
OT 4.375% Jun 2014	PTOTE1OE0019	Fixed rate	Benchmark	4,200
OT 3.85% April 2021	PTOTEY0E0007	Fixed Rate	Benchmark	5,077
OTRV Jul 2004	PTOTVEOE0000	Floating rate	Regular	327

Transaction Description

A derivative based solution to improve the deficit/GDP ratio by around €370mm in 2005 and €450mm in 2006, while also satisfying other important liability management objectives. Higher savings can be achieved by increasing the size of the transaction.

It consists in the execution of three 30 year interest rate swaps. The Republic of Portugal would achieve the following objectives:

Extracting Cost Savings from the shape of the curve: we have estimated positive net interests of around €510mm in February 2006 (€370mm of which to be accounted in 2005).

Interest Rate Cost Smoothing: by swapping the higher-than-market coupon expenses that the Republic of Portugal faces in February 2005 and 2006 over a longer maturity.

Locking-in historically low long term interest rate levels. Citigroup believes that current historically low interest rates continue to represent a significant market opportunity for the Republic of Portugal to extend the duration of its debt portfolio, locking-in future fixed funding rates.

Reducing the cost of extending duration by selling options. The options sold by the Republic of Portugal are 'covered options': if and when expiring in-the-money, they would cap some of the Republic of Portugal's potential upside, rather than generating an outright loss.

Swap 1

Swap 1- OT 9.5% Feb 2006

Reference OT: OT 9.5% Feb 2006
Notional Amount: 831mm euro (entire issue outstanding)
Swap Start date 23 February 2005 (Retroactive Start)
Swap Maturity date 23 February 2036

I) Interest Rate Period from 23 February 2005 to 23 February 2006

Citi pays: 9.5% (annual, ACT/ACT)
Citi receives: 6mo Euribor – 200bps (semi-ann. ACT/360)

II) Interest Rate Period from 23 February 2006 to 23 February 2036

Citi receives: 3.70% (annual, ACT/ACT) every 23 February
Citi pays: 6 month Euribor +0bps (semi-ann. ACT/360) every 23 February/August, subject to a Cap at 3.75%, maturing on 23 February 2011

Option: from 23 February 2011 and every year thereafter Citi has the right to switch the fixed rate into 6m Euribor -100bps

Swap 2

Swap 2- OT 6.625% Feb 2007

Reference OT: OT 6.625% Feb 2007
Notional Amount: 2,086mm euro (entire issue outstanding)
Swap Start date 23 February 2005 (Retroactive Start)
Swap Maturity date 23 February 2037

I) Interest Rate Period from 23 February 2005 to 23 February 2007

Citi pays: 6.625% (annual, ACT/ACT)
Citi receives: 6mo Euribor – 200bps (semi-ann. ACT/360)

II) Interest Rate Period from 23 February 2007 to 23 February 2037

Citi receives: 4.30% (annual, ACT/ACT) every 23 February
Citi pays: 6 month Euribor +0bps (semi-ann. ACT/360) every 23 February/August, subject to a Cap at 3.75%, maturing on 23 February 2012

Option: from 23 February 2012 and every year thereafter Citi has the right to switch the fixed rate into 6m Euribor -100bps

Swap 3

Swap 3- OT 5.85% May 2010

Reference OT: OT 5.85% May 2010
Notional Amount: 5,217mm euro (entire issue outstanding)
Swap Start date 20 May 2005 (Retroactive Start)
Swap Maturity date 20 May 2037

I) Interest Rate Period from 20 May 2005 to 20 May 2007

Citi pays: 5.85% (annual, ACT/ACT)
Citi receives: 6mo Euribor – 200bps (semi-ann. ACT/360)

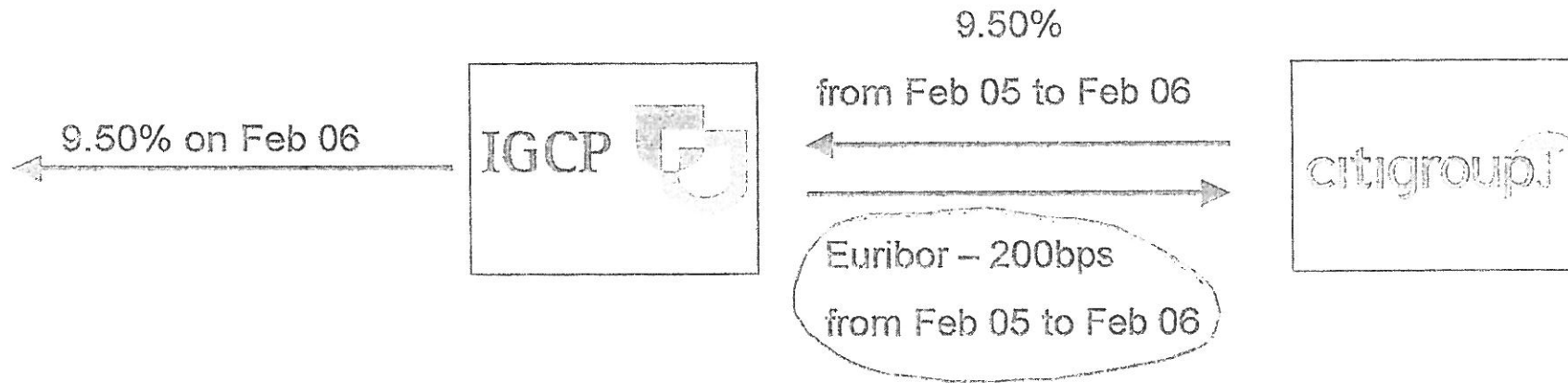
II) Interest Rate Period from 20 May 2007 to 20 May 2037

Citi receives: 4.20% (annual, ACT/ACT) every 20 May
Citi pays: 6 month Euribor +0bps (semi-ann. ACT/360) every 20 May/November, subject to a Cap at 3.75%, maturing on 20 May 2012

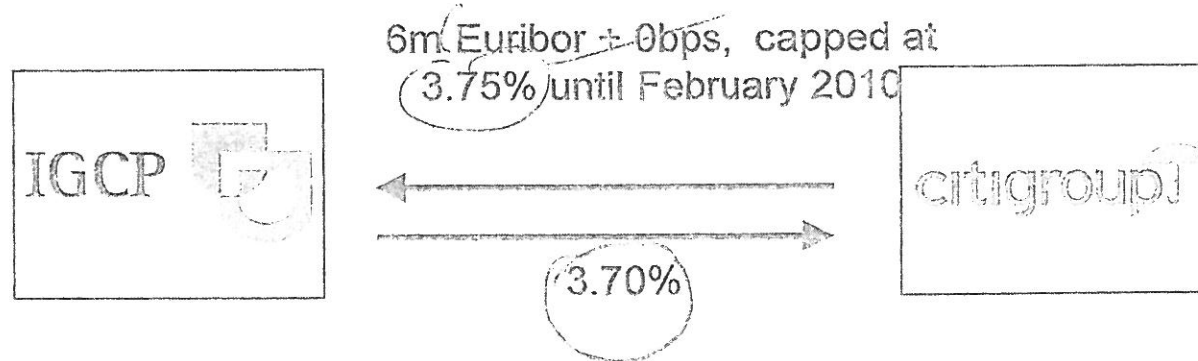
Option: from 20 May 2012 and every year thereafter Citi has the right to switch the fixed rate into 6m Euribor -100bps

Swap 1 Overview

From 23 February 2005 to 23 February 2006



From 23 February 2006 to 23 February 2036

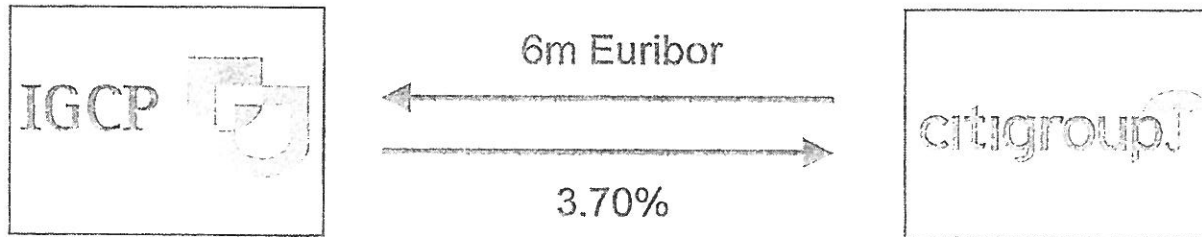


Swap 1 Overview

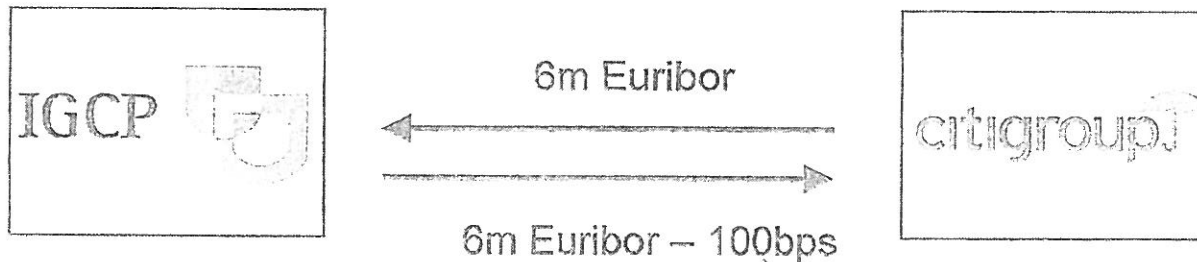
Citigroup Option:

Citigroup has the right to transform Fixed Rate that the IGCP pays into 6m Euribor - 100bps, in February 2011 and every year thereafter

Option Not Exercised

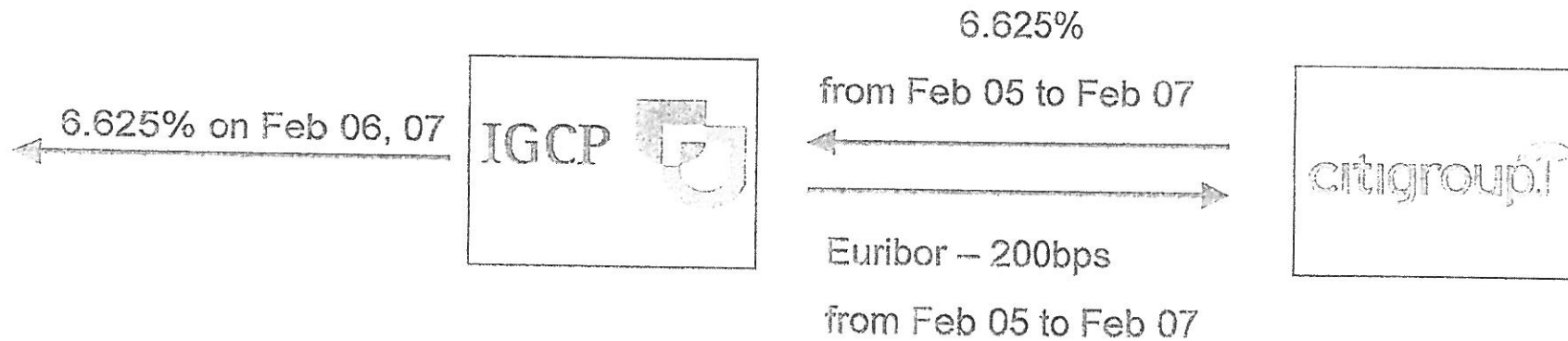


Option Exercised

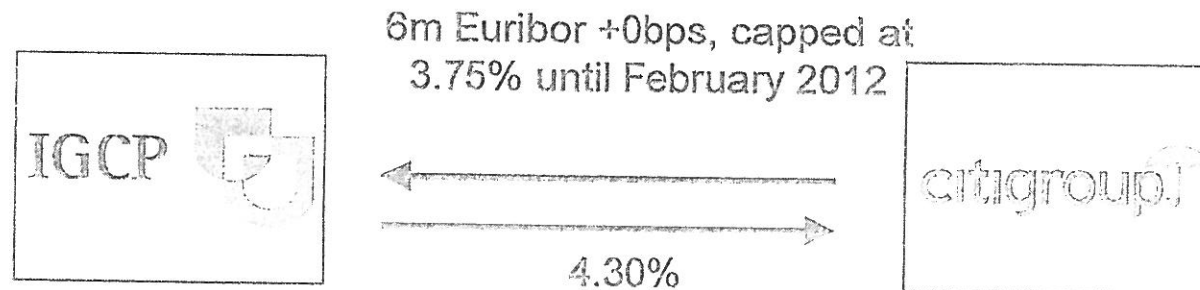


Swap 2 Overview

From 23 February 2005 to 23 February 2007



From 23 February 2007 to 23 February 2037

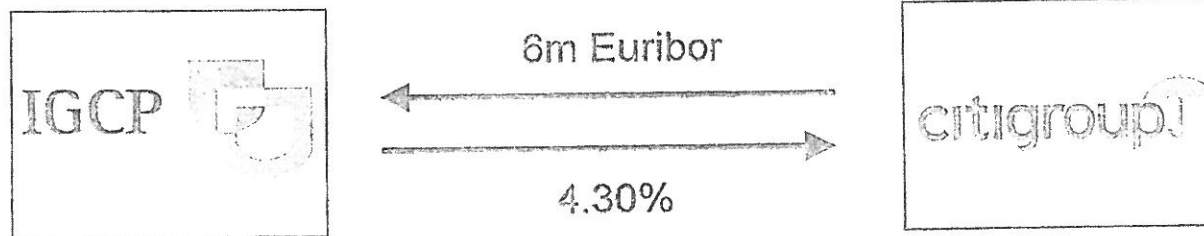


Swap 2 Overview

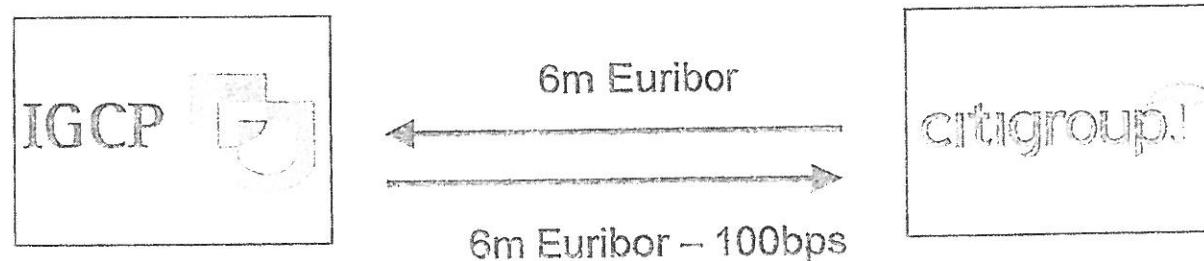
Citigroup Option:

Citigroup has the right to transform Fixed Rate that the IGCP pays into 6m Euribor -100bps, in February 2012 and every year thereafter

Option Not Exercised



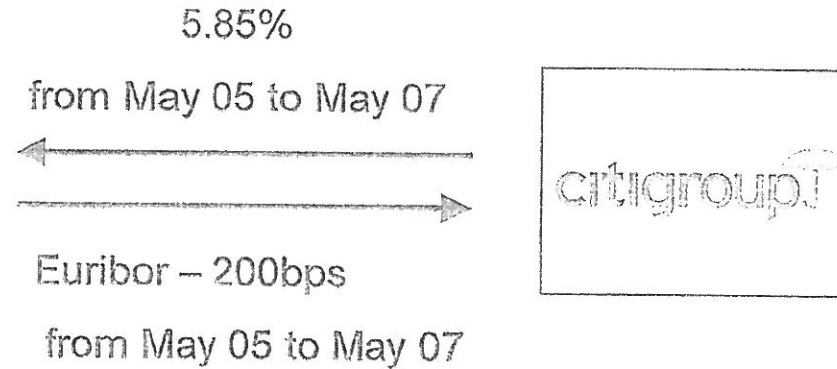
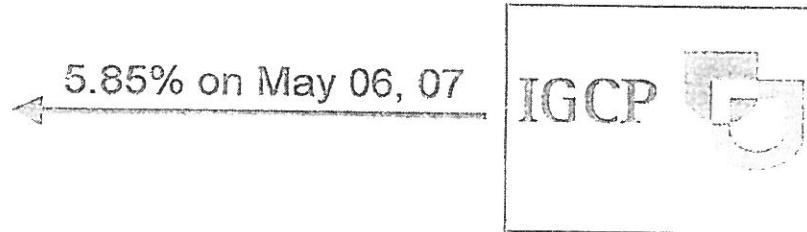
Option Exercised



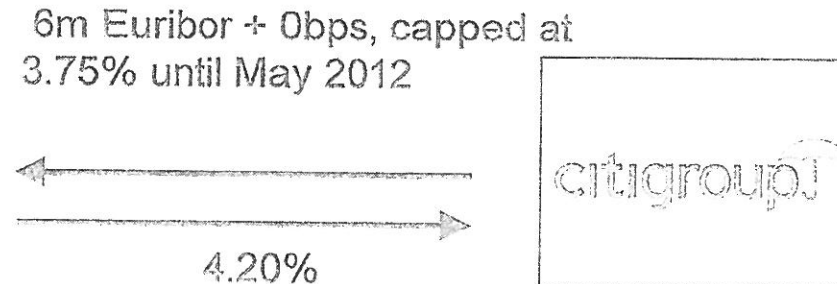
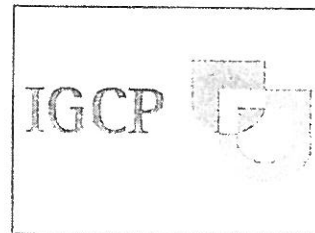
Swap 3 Overview



From 20 May 2005 to 20 May 2007



From 20 May 2005 to 20 May 2037



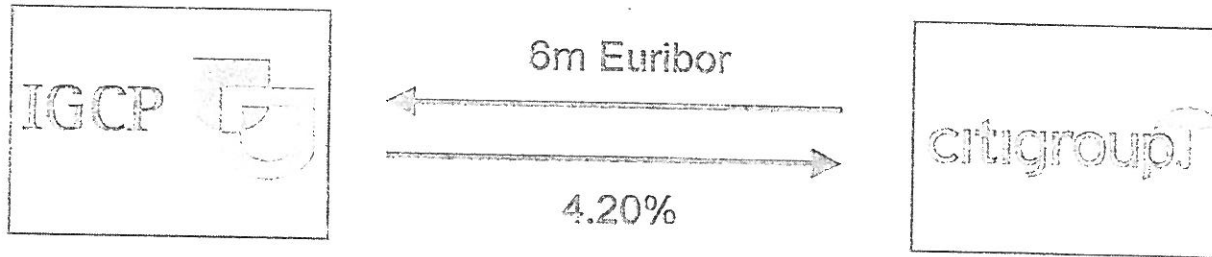
Swap 3 Overview



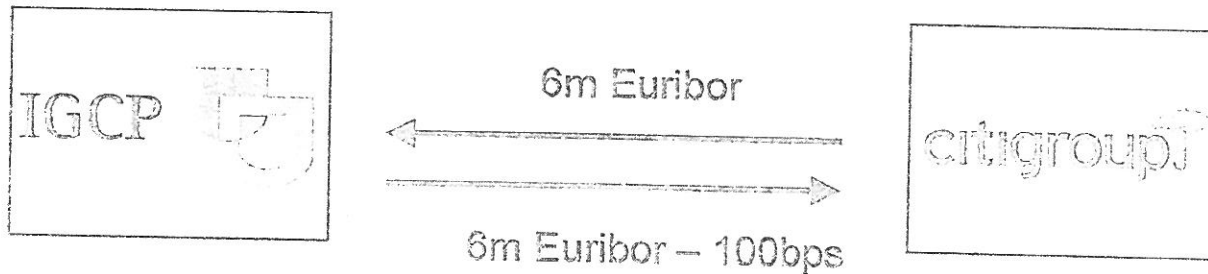
Citigroup Option:

Citigroup has the right to transform Fixed Rate that the IGCP pays into 6m Euribor - 100bps, in May 2012 and every year thereafter

Option Not Exercised



Option Exercised



- Swaps have become a common feature of highly developed debt strategies for EU12 Governments. S&P acknowledge that partly as a result of swaps debt managers have been successful in reducing the average cost of government borrowing and smoothing interest payments and amortization schedules thereby contributing to fiscal improvements
- S&P summarized the issues involved in a paper dated September 2002, "Accounting for Innovation: Treatment of Off-Balance Sheet Public Sector Financing Operations", in which they acknowledge that "trying to take advantage of the leeway that public accounting rules allow is a legitimate objective." Governments increasingly care about reporting of fiscal performance
- Following an amendment to European System of Integrated Economic Accounts (ESA) 95 in 2001, streams of interest payments resulting from swap agreements and forward rate agreements count towards deficit calculations but not to net borrowing (debt) calculations
- EC governments report national accounts to Eurostat which publishes a summary in an annual news release referencing deficits as a % of GDP after derivatives, highlighting the impact of swap transactions. In 2004, Eurostat said the positive impact on the headline deficit number mainly affects Sweden (0.24%), Denmark (0.20%), Finland (0.16%) and Austria (0.15%).
- S&P say that they will take account of such transactions when analyzing government credit risk and that as of today these transactions have had no material impact. They say that if "innovative" operations were to impact future fiscal flexibility in a more substantial way than in the past, then rating implications are possible. However S&P include Securitization, PFI projects and the use of non-consolidated borrowing institutions as well as swaps in their definition of innovative operations. Fitch and Moody's have said the same



EURO-INDICATORS
news release

106/2003 - 15 September 2003

Second notification of deficit and debt data for 2002
**Euro-zone government deficit at 2.2% of GDP
and public debt at 69.0% of GDP**

7. Government expenditure and revenue are reported to Eurostat under the ESA95 transmission programme. They are the sum of non-financial transactions of the general government accounts, and include both current and capital transactions. For details, see Commission Regulation No. 1500/2000 of 10 July 2000. It should be noted that, following an amendment to ESA95, the government balance (which may be calculated as the difference between total government revenue and expenditure) is no longer the same under ESA95 as that of the excessive deficit procedure. Regulation (EC) No 2558/2001 on the reclassification of settlements under swaps agreements and forward rate agreements implies that there are two relevant definitions of government deficit/surplus:

- The ESA95 definition of net lending/net borrowing does not include streams of interest payments resulting from swap agreements and forward rate agreements.
- For the purpose of the excessive deficit procedure, net lending/net borrowing of general government includes streams of interest payments resulting from swap and forward rate agreements.

Concerning 2002, for most Member States the difference, if any, between the two balances is minor (less than 0.1% of GDP), except in Sweden (0.24%), Austria (0.20%), and Italy (0.15%).

	1999	2000	2001	2002
Portugal				
(million euro)				
GDP mp	108 030	115 548	123 054	129 200
Government deficit (-) / surplus (+)	-3 073	-3 267	-3 268	-3 500
% of GDP	-2.8	-2.8	-2.7	-2.7
Government expenditure	45.3	45.2	46.3	46.1
% of GDP	42.4	42.3	42.1	43.3
Government revenue	42.4	42.3	42.1	43.3
% of GDP	69 857	81 570	89 333	75 054
Government debt	69 857	81 570	89 333	75 054
% of GDP	64.3	53.3	55.5	58.1
Primary surplus	0.4	0.4	-1.1	0.3
% of GDP				
Italy				
(million euro)				
GDP mp	1 107 094	1 166 548	1 220 147	1 288 940
Government deficit (-) / surplus (+)	-19 125	-7 544	-32 220	-28 059
% of GDP	-1.7	-0.6	-2.6	-2.2
Government expenditure	49.0	43.9	46.6	47.7
% of GDP	47.1	48.2	45.8	46.2
Government revenue	47.1	48.2	45.8	46.2
% of GDP	1 279 249	1 200 459	1 320 038	1 342 887
Government debt	1 279 249	1 200 459	1 320 038	1 342 887
% of GDP	114.9	110.0	108.5	103.7
Primary surplus	6.0	6.8	3.8	3.4
% of GDP				

The difference between revenue and expenditure may not exactly be equal to the deficit/surplus for the countries where swaps agreements and forward rate agreements have been implemented. In 2002 this mainly concerns Sweden (0.24% of GDP), Denmark (0.01%), Finland (0.15%), and Austria (0.15%).



EURO-INDICATORS
news release

117/2004 - 23 September 2004

Second notification of deficit and debt data for 2003
**Euro-zone government deficit at 2.7% of GDP
and public debt at 70.7% of GDP**

7. Government expenditure and revenue are reported to Eurostat under the ESA95 transmission programme. They are the sum of non-financial transactions of the general government accounts, and include both current and capital transactions. For details, see Commission Regulation No. 1500/2000 of 10 July 2000. It should be noted that, following an amendment to ESA95, the government balance (which may be calculated as the difference between total government revenue and expenditure) is not the same under ESA95 as that of the excessive deficit procedure. Regulation (EC) No 2558/2001 on the reclassification of settlements under swaps agreements and forward rate agreements implies that there are two relevant definitions of government deficit/surplus:

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Concerning 2003, for most Member States the difference, if any, between the two balances is minor (less than 0.1% of GDP), except in Sweden (0.24%), Denmark (0.20%), Finland (0.16%), and Austria (0.15%).

	2000	2001	2002	2003
Portugal				
(million EUR)				
GDP mp	115 548	122 550	128 597	130 007
Government deficit (-) / surplus (+)	-3 267	-3 365	-3 467	-3 537
% of GDP	-2.8	-2.7	-2.7	-2.8
Government expenditure	45.2	46.2	45.9	47.7
% of GDP	42.3	41.9	43.2	44.9
Government revenue	42.3	41.9	43.2	44.9
% of GDP	61 566	68 334	75 070	78 345
Government debt	61 566	68 334	75 070	78 345
% of GDP	53.3	58.4	58.4	60.2
Primary balance	+ 0.4	- 1.2	+ 0.3	+ 0.1
% of GDP				
Italy				
(million EUR)				
GDP mp	1 166 548	1 218 535	1 260 428	1 300 026
Government deficit (-) / surplus (+)	-7 544	-32 262	-28 059	-31 832
% of GDP	-0.6	-2.6	-2.2	-2.4
Government expenditure	43.9	46.6	46.1	47.7
% of GDP	46.9	46.7	45.0	46.5
Government revenue	46.9	46.7	45.0	46.5
% of GDP	1 297 106	1 247 835	1 360 253	1 381 428
Government debt	1 297 106	1 247 835	1 360 253	1 381 428
% of GDP	111.2	102.4	107.9	106.2
Primary balance	- 5.8	+ 3.9	+ 0.5	+ 2.9
% of GDP				

The difference between revenue and expenditure may not exactly be equal to the deficit/surplus for the countries where swaps agreements and forward rate agreements have been implemented. In 2003 this mainly concerns Sweden (0.24% of GDP), Denmark (0.20%), Finland (0.16%), and Austria (0.15%).

Appendix – Accounting Considerations

Example

Sovereign A issues *debt* to Citigroup under which Sovereign will receive € 500mm during year 1 and repay €500mm during year 2 (ignoring the time value of money). The accounting for year 1 would be:

	Cash	Debt	Deficit	
Eurostat (SGP under ESA95)	+500	+500	0	Impact on SGP measures
Corporate Accounts	+500	+500	0	

Sovereign B enters into a customized funding *swap* (not a standard plain vanilla interest swap) with Citigroup under which Sovereign will receive € 500mm during year 1 and repay € 500mm during year 2 (ignoring the time value of money). The accounting for year 1 would be:

	Cash	Debt	Deficit	
Eurostat (SGP under ESA95)	+500	0	-500	(reduces deficit)
Corporate Accounts	+500	+500	0	

Corporate Accounts are included for comparison to what the accounting treatment would look like for an entity reporting under International Financial Reporting Standards

The accounting above is highly simplified for the purpose of illustration

EU Member States (Sovereigns) are required under the “Stability and Growth Pact” (SGP) to:

- Keep government deficit as a percentage of GDP below 3%; and
- Keep government debt outstanding as a percentage as GDP below 60%

Deficit and debt calculations are prepared by Eurostat based on the data supplied by Sovereigns from their national accounts. Sovereigns generally do not provide disclosures regarding utilization of derivatives. Eurostat employs basic calculations to roughly estimate such activity.

Eurostat accounts are based on “cash-basis accounting principles” and the concepts of “fair value accounting” and “hedge accounting” are generally not applied.

Differences in the accounting treatment for debt versus funding swaps for the purpose of determining the deficit/GDP ratio may provide incentives for Sovereigns to use such swaps.

In brief, the difference can be highlighted as follows:

- *Debt*. Funding received through debt issuance will generally be recorded as a liability (no direct impact on deficit calculations). Annual interest payments will impact the current year’s deficit
- *Funding swap*. Funding received through funding swaps will not be recorded as a liability. Instead the funds received will immediately reduce the current year’s deficit (The swap will effectively be kept “off balance sheet”.)