PORTUGAL: LETTER OF INTENT

Lisbon, October 14, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

1. The attached Memorandum of Economic and Financial Policies (MEFP) describes the progress made in recent months towards the objectives laid out in our program supported by the Extended Arrangement. It also updates previous MEFPs and highlights the policy steps to be taken in the months ahead.

2. While we remain strongly committed to the program's policies and objectives, the challenging domestic and external environment is weighing on program performance. The fiscal outlook has deteriorated considerably, reflecting mainly the impact of the economic rebalancing on tax bases and revenue performance (see paragraphs 1 and 3 of the MEFP). Although spending has been tighter than envisaged in the program, a large fiscal gap has now emerged and the initial program targets are no longer achievable. As a result—and in spite of having met the end-June quarterly performance criteria on the general government cash deficit and debt—we estimate that the end-September target on the general government cash deficit has been missed (see Table 1).

3. We have started to settle the stock of existing domestic arrears and have advanced the implementation of the new commitment control systems. Nevertheless, the underlying arrear position has continued to deteriorate—although with smaller increases in recent months, resulting in further breaches of the related indicative target under the program. The operational restructuring of SOEs is being successfully implemented and we are assessing options to strengthen their long-term financial viability. Our policy efforts to preserve financial stability have continued, and further steps have been taken to promote competitiveness, growth, and employment. All the structural benchmarks for the fifth review were met.

4. While the program strategy remains appropriate, a recalibration of the fiscal path is needed at this difficult juncture to avoid imposing too large a social and output cost (see MEFP paragraph 5). Additional corrective measures will be implemented this year to limit the deficit to 5 percent of GDP in 2012. The 2013 Budget will aim at a deficit of 4.5 percent of GDP and will be underpinned by permanent measures designed to limit the impact of fiscal consolidation on growth and the poorest segments of the population. We are implementing the new law on commitment control in order to avoid further accumulation of domestic arrears. Special attention is being given to local governments and the health sector where the main challenges are concentrated.

5. The achievement of an orderly deleveraging of the economy remains a key objective under our program and we are developing alternative options to facilitate credit to productive firms, in particular SMEs, by fostering the diversification of financing alternatives. The bank capital augmentation exercise due by June 2012 has been successfully completed and we will continue to closely monitor compliance with capital requirements and take prompt and appropriate actions if needed.

6. We are implementing the deep structural reforms already committed to under the program, and we will intensify efforts in areas with high potential to create jobs. For the fifth review, we present a new initiative to substantially streamline licensing requirements and procedures to create a business-friendly environment that should help spur new investment and relieve the heavy regulatory burden on small and medium firms. Building on the good results already secured in our privatization program, we will broaden its scope, releasing more resources to the private sector.

7. On the basis of the strength of the policies defined in this letter, and in light of our performance under the program, including the corrective measures already taken as a prior action for this review, we request the completion of the fifth review under the Extended Arrangement, the sixth purchase under the arrangement in the amount of SDR 1,259 million, as well as a waiver of nonobservance of the end-September cash deficit performance criterion and a waiver of applicability of end-September debt performance criterion.

8. We remain confident that the policies described in the current and previous MEFPs are adequate to achieve the objectives under the program. We stand ready to take additional measures should they be needed to meet the objectives of the economic program and will consult with the IMF, the European Commission, and the ECB, in advance of any necessary revisions to the policies contained in this letter and attached Memorandum.

9. This letter is copied to Messrs. Juncker, Rehn, and Draghi.

Sincerely yours,

/s/	/s/
Vítor Gaspar	Carlos da Silva Costa
Minister of State and Finance	Governor of the Banco de Portugal

Attachments: 1. Memorandum of Economic and Financial Policies (MEFP)
2. Technical Memorandum of Understanding (TMU)