



Júlio Pomar

*Fernando Pessoa
encontra D. Sebastião
num caixão sobre um
burro ajaezado à Andaluza*

(Detail)

MACROECONOMIC BACKGROUND

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*Fernando Pessoa encontra D. Sebastião
num caixão sobre um burro ajaezado à Andaluza
1985*

*Oil on canvas
157 x 154 cms*





Macroeconomic Background

World Economy

Overview

2004 saw world economic growth of more than 4%, as opposed to the preceding year's 3.5%. Contributory factors were higher US activity rates and the significant growth of several emerging markets and countries such as China, Brazil, Russia and India, which are going through a major development stage.

The signs of recovery, which cooled off in the second half of the year, occurred in a context of major oil price hikes, reaching all-time highs of USD55.67, per barrel, in October. This derived from political and military instability in Iraq, tensions in major oil producing countries and huge demand from China.

There were large differences in terms of the evolution of the principal geographical areas. Growth was higher in the US and Asian economies, particularly China, in contrast to moderate European Union growth.

US GDP growth was estimated at 4.4%, as against the preceding year's 3.1%. This was largely sustained by a 13.4% increase in private consumption and investment,

offsetting the moderate contribution made by net external demand, particularly in second half. Budget policy remained expansionary, with external and public deficit increases. Economic expansion and the intensification of inflationary pressures forced the FED to implement a new cycle of interest rate increases in second half, increasing the reference rate on five occasions. Owing to successive interventions the FED's reference rate closed the year at 2.25% as against 1% at the end of the preceding year.

Asian economic performance as a whole was particularly marked by the 9.2% increase in growth in China. A combination of external market buoyancy, investment and private consumption were determining factors in sustaining growth, in respect of which the Chinese authorities implemented several administrative measures designed to prevent economic overheating, notably restrictions on investment project credit approvals. The principal reference rate (maturity period of one year), unchanged since 1995, was increased from 5.31% to 5.58% at end October 2004.

Japanese GDP grew 2.6%, although showing signs of weakening in 1st quarter (4% year-on-year) owing to lower investment and exports. Exports grew by 10.5% in 4th quarter as opposed to 18% in 2nd quarter.

Rates of Change (%)

	GDP		Inflation		Unemployment rate	
	2003	2004	2003	2004	2003	2004
European Union (25)	0.9	2.3	2.1	2.2	9.1	9.1
Eurozone	0.5	2.0	2.1	2.1	8.9	8.9
Germany	-0.1	1.6	1.0	1.7	9.6	9.7
France	0.5	2.5	2.2	2.3	9.4	9.6
United Kingdom	2.2	3.0	1.4	1.4	5.0	4.9
Spain	2.5	2.7	3.1	3.1	11.3	11.1
Italy	0.3	1.1	2.8	2.3	8.6	8.3
USA	3.1	4.4	2.3	2.6	6.0	5.5
Japan	2.4	2.6	-0.3	-0.2	5.3	4.8
Russia	7.3	7.1	12.0	10.5		
China	9.1	9.2	3.2	5.0		
India	7.2	6.4	3.8	4.7		
Brazil	-0.2	4.0	14.8	6.6		

Source: EC, Economic Forecasts for October 2004; Eurostat Euro-indicators, Perspectives Economiques de l'OCDE, Moody's Investors Service.

European Union

Ten new member states joined the European Union in May 2004.

GDP growth in the 25 EU countries hit 2.3%. This signified an increase in the rate of economic activity over the preceding year, albeit at a lower rate than that of the principal world economies.

Eurozone GDP growth was around 2%. Recovery was also mainly based on higher exports benefiting from marked growth in world trade. There was a slight increase in domestic demand and investment, largely translating low business confidence, although inflation and unemployment remained stationary, at around 2.1% and 8.9%, as was the case with the public sector to GDP deficit of around 2.9%.

Growth rates in non-Eurozone countries, particularly the new member states, were relatively high in 2004.

European Union and Eurozone Economic Indicators

(%)

	European Union		Eurozone	
	2003	2004	2003	2004
Rates of Change				
Gross domestic product (GDP)	0.9	2.3	0.5	2.0
Private consumption	1.3	1.7	1.0	1.2
Public consumption	1.9	1.8	1.6	1.5
GFCF (capital investment)	-0.1	2.3	-0.5	1.3
Domestic demand	1.5	2.3	1.2	1.9
Exports	0.9	6.2	0.2	6.0
Imports	2.3	6.6	2.0	6.3
Inflation Rate	1.9	2.0	2.1	2.1
Ratios				
Unemployment rate	9.1	9.1	8.9	8.9
General government deficit as a % of GDP	-2.8	-2.8	-2.7	-2.9

Source: EC, Economic Forecasts for October 2004; Eurostat Euro-indicators.

Domestic Economy

Overview

Real GDP growth in Portugal, in 2004, was 1.1 %, as against the preceding year's fall of 1.3%. It was sustained by a 1.9% increase in domestic demand, resulting from higher private consumption, reflecting increased business confidence associated with improved international economic conditions. Domestic demand was also fuelled by a moderate increase in investment (GFCF), which had regressed considerably in the last two years. Particular reference should be made to the highly favourable growth of corporate investment. Domestic demand expansion generated an increase in the economy's financing requirements from 3.6% to 5.4% of GDP and a fresh estimated reduction in individual savings from 11.7% to 11% of disposable income.

trade. Although export growth, at 6.8%, was appreciable, the commercial balance worsened in comparison to previous years, owing to the sharp 8% increase in imports of capital goods and consumer durables, particularly deriving from higher domestic demand.

Average inflation was 2.5% as against the preceding year's 3.3%. Inflationary trends derived from a combination of the euro's appreciation against the principal currencies and its implications on imported good prices and a slowing down of unit labour costs which, to a large extent, made it possible to offset 2004 energy product price increases.

Budget consolidation was a dominant issue in 2004, owing to the difficulty involved in reducing the structural deficit, which required such extraordinary measures as the transfer of the CGD Employees Pension Fund's and other funds'

Domestic Economic Indicators

	2002	2003	2004
GDP (real rates of change)	0.5	-1.3	1.1
Private consumption	0.5	-0.7	2.2
Public consumption	2.2	0.5	0.6
GFCF (investment)	-5.5	-9.6	1.8
Domestic demand	-0.5	-2.5	1.9
Exports	2.4	4.1	6.8
Imports	-0.7	-0.5	8.2
Inflation Rate	3.6	3.3	2.5
Ratios			
Unemployment rate	5.1	6.3	6.7
Current and capital balance as a % of GDP	-5.6	-3.6	-5.4
General government deficit as a % of GDP	-2.7	-2.8	-2.9
Government debt as a % of GDP	58.4	60.0	61.6

Source: INE (National Statistics Institute) and Bank of Portugal - Economic Bulletin, December 2004.

The upturn in activity was particularly visible in first half. This reflected a combination of the effects of such one-off events as the Euro 2004 Football Championship and more permanent developments such as improvements in world

assets to Caixa Geral de Aposentações (National Pensions Scheme) to achieve the General Government to GDP deficit of 2.9% and comply with the 3% maximum established in the SGP (Stability and Growth Pact).

Deposits and Credit Aggregates

Eurozone monetary and credit aggregates were impacted by continued low interest rates and greater economic activity. Growth of the M3 liquidity aggregate, excluding currency in circulation, in Portugal, (particularly other deposits and deposit-like instruments up to 2 years) grew at a higher rate than last year as a reflection of economic buoyancy, albeit moderate.

A determining factor in year-on-year growth in banking system deposits of 3.2% was the 2.9% increase in individual customers' (including emigrants) deposits as against last year's retraction of 0.2%.

December, in turn, saw a slight increase in the annual rate of change of total domestic lending, from 6.6% to 7.4%, sustained by greater buoyancy in corporate loans, particularly in last quarter and consumer finance and loans for other purposes. Notwithstanding the 11.8% to 10.5% reduction in the rate of change of mortgage lending, based on the end December balance, it remained relatively stable, during the year, at around 11.6%.

Monetary Aggregates in Portugal

Annual rates of change

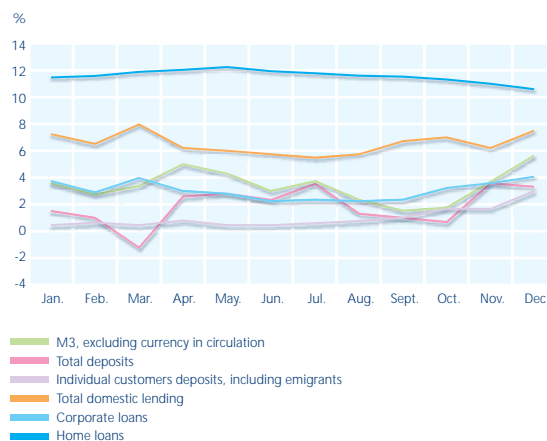
	2003	2004
M3, excluding currency in circulation	4.2	5.6
Total deposits ^(a)	1.0	3.2
Individual customers' deposits ^(a)	-0.2	2.9
Total domestic lending ^(b)	6.6	7.4
Corporate loans ^(b)	2.7	4.1
Mortgages ^(b)	11.8	10.5
Consumer Finance and for Other Purposes ^(b)	2.3	4.5

Source: Bank of Portugal – Statistics Bulletin, February 2005.

(a) Rates of change based on end of month balances.

(b) Annual rates of change based on balances corrected by the Bank of Portugal. Credit aggregates include securitised loans.

Monetary and Lending Aggregates - 2004 (year-on-year)



Source: Bank of Portugal.

The credit aggregates analysis included securitised loans of €16.1 billion, representing around 8% of domestic banking system credit, at year end.



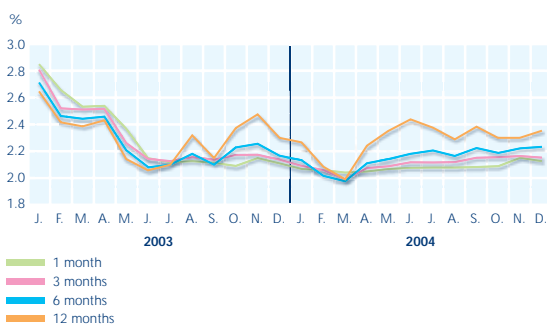
Interest Rates

Euribor rates for the shorter term maturities fell up to the end of the first quarter, in line with expectations of ECB reference rate cuts. As the said cuts failed to materialise, rates returned to their former levels, remaining highly stable up to year end, within a narrow band slightly higher than the ECB reference rate which remained at 2% for the year as a whole.

For the longer maturities, the evolution of the said rates in the early months of the year was "V" shaped, as in the case of shorter term maturities. Mid-year saw a drop in rates extending up to December, particularly reflecting a less optimism over Eurozone growth.

Greater nominal interbank interest rates stability, in 2004, impacted banks' lending and borrowing rates, which remained stable and similar to those of the preceding year.

Euribor (*)



(*) Values relative to the last day of the month.
Source: Bank of Portugal.

The interest rate on new loans with a maturity of up to one year, for amounts of more than €1 million, for "non-financial companies", was 3.53% in December, as against 3.59%, for the same month 2003, in comparison to 3.39% and 3.43% for mortgages, respectively.

Borrowing rates on for individual customers' deposits with a maturity of up to 2 years were similar to the December 2003 and 2004 figures of 1.99% and 1.98%, respectively.

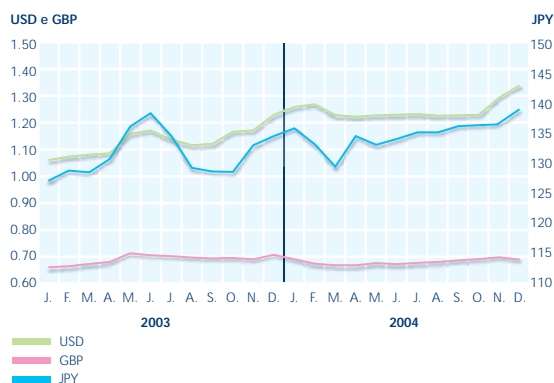
Exchange Rates

The euro appreciated, once again, against the dollar in 2004, translating the imbalances existing in the US economy's external and public deficits.

Year start, in which the euro maintained its upwards trajectory, hitting an all-time first quarter high against the US currency, was followed by a certain element of volatility deriving from one-off increases in the dollar's worth associated with expectations of FED fund rate increases. The euro, after the said period, continued to appreciate to USD 1.36 at year end in comparison to the end of 2003 figure of 1.26.

Euro Exchange Rates

(average monthly values)



Source: Bank of Portugal.

In average annual terms, the euro increased in value by 10% and 2.7% over the US dollar and Japanese yen, respectively, while depreciating 1.9% against sterling.

Capital Market

Shares

Evolution on the principal stockmarket indices in 2004, was modest, in comparison to 2003. The increase in the US Dow Jones Index was only 3% and no more than 9% for Nasdaq. The Nikkei achieved 8% while increases in the Paris, Frankfurt and London indices were also less than 10%. The

best European performers were Madrid and Milan, with 17% increases. Lisbon came third with a PSI 20 increase of 12.6%.

After a first quarter with large gains, mainly owing to investor confidence in world economic recovery, economic confidence was significantly eroded, in the coming months, by a combination of such factors as the Madrid terrorist attack, continued political and military instability in Iraq and oil price hikes. Most markets only recovered in the last quarter of the year, fuelled by good US economic performance, continued low interest rates and improved corporate results.

The Portuguese PSI 20 index, fell from a March peak through to August, recovering in the last few months to close the year with gains of 12.6%. Only one PSI-20 listed share closed the year with losses and eight recorded gains of more than 30%. Secondary share market dynamism was also evident in the 46% growth in trading and respective 24% stockmarket capitalisation.

The primary market saw two new entrants – Sacyr Vallehermoso and Media Capital – the latter resulting from an initial public offering (IPO).

Bond Market

Bond trading was also down, both in terms of stockmarket trading which fell by half and the 5% reduction of the MEDIP (Special Public Debt Market). Including the latter market, treasury bonds trading increased more than fourfold, although last year's data refer only to the half of the year in which they returned to the market. MEDIP grew 3%.

Although there was a first half oscillation in long term yields on Portuguese government debt, the second half trend was clearly downwards, with a reduction of 4.47% in June to 3.86% in December. The differential of around 15 bp with German rates in the first half of the year, narrowed to around 5 bp by year end.

