

Portugal Requests A Bail-out: We now enter the critical phase of the euro sovereign debt crisis

Introduction

The announcement that Portugal is to seek financial aid from the EU was hardly a surprise and, indeed, the Euro has remained strong and Spanish bond yields (the next most vulnerable country) have actually tightened since the news.

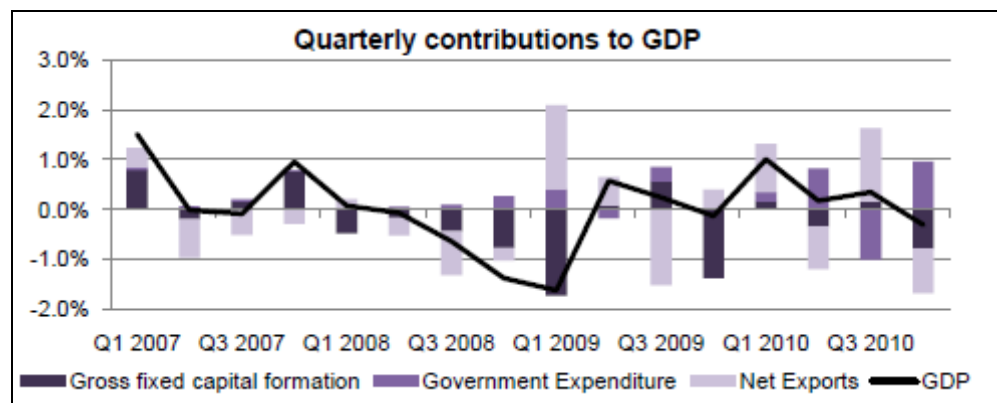
The decision was triggered by an unsuccessful auction yesterday of €1bn of 6 month and 12 month bills that Portugal had to pay an interest rate of 5.9% to secure. The Portuguese banks have also been increasingly reluctant to buy their country's debt and the cost of financing the deficit was spiralling upwards. With the opposition voting against the austerity package proposed by the government it has left a political vacuum that made a bail-out inevitable.

Why a bailout was inevitable

The amount of money that Portugal will need is estimated to be between €70-90bn. In the short term the government faces two large redemptions on its bonds in mid April and June. Further ahead, it needs to raise €35bn for bond redemptions and €25bn to finance its deficit by mid-2014. The loan will have to cover this and, as was the case for Ireland, allow for the potential capital needs and funding of its banks. The terms of the loan are likely to be similar to those given to Greece with an interest rate of around 5% over a period of 7-8 years. This is much more affordable than is currently available to Portugal in the open market where it is paying around 10% for 5 and 10 year money.

Although there is a domestic political crisis that renders negotiations more difficult, the bail-out is likely to get done because needs must (the government would struggle to find the money to finance the April bond) and the opposition has sanctioned it.

The problems of Portugal differ from Greece and Ireland and have been mainly caused by having very high private sector leverage and a chronic lack of economic competitiveness. The most recent economic data shows the economy shrunk by 0.3% in the final quarter of 2010 revealing an uncompetitive export sector and a public sector trying to implement substantial fiscal reforms. The changing mix of the economy leading to declining growth is shown in the chart below.



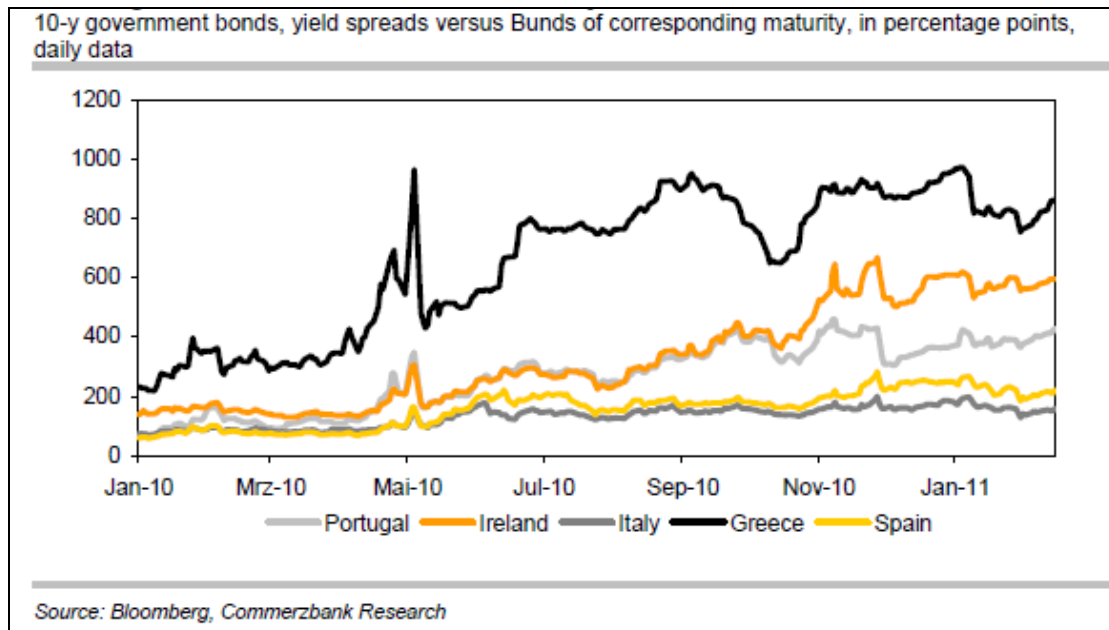
Source: LSR

The danger is that any austerity programme agreed as part of a bail-out will depress growth even further and lead to a higher level of public debt, as has been the case in Greece. In setting the terms of the austerity measures the authorities need to be aware of the necessity to introduce reforms to the economy that will make it more competitive and not endanger growth too much.

Will contagion now be contained?

For markets the key question is whether the Pandora's Box of countries receiving bailouts can be firmly shut with lock and key or whether the much feared contagion will spread to Spain

and Italy. In recent months the market has become much more optimistic on Spain, the next domino that could fall, and its bonds have decoupled from the three smaller economies, as the chart below shows.



Spain has shown signs of becoming more competitive with its export sector doing better, consumption has held up more than expected and the government has gained credit for implementing reforms to tackle its fiscal deficit and ailing banking system. However, the economy is still weak with GDP growth barely in positive territory and unemployment shamefully over 20%. The banking sector has addressed its problems by raising capital and through mergers of the weaker regional banks, the *cajas*, but they are still heavily exposed to the weak construction sector. If there is a further downturn in the building industry in Spain the banks could still be exposed in a similar way to the Irish banks that were brought down by their own property boom and bust.

The EU summit at the end of March was flagged as a 'Grand Bargain' to provide a permanent solution to the sovereign debt crisis but in the event it was a tepid compromise that failed to enact the necessary radical reforms (such as launching a Euro bond or allowing purchases of bonds in the secondary markets for EU institutions other than the ECB). Hence it will not prevent future contagion if financial and economic conditions worsen again in Spain or Italy and as we have seen with the other three periphery countries market dynamics are very powerful and will overwhelm any rhetoric or bond purchases by the ECB. The crisis has now entered its critical phase and we should be alert to the risks.

Ted Scott April 2011