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FOCUS NOTES

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Portugal: Additional official funds will be required when current program ends

- Additional funding seems unavoidable when the Portuguese bail-out program terminates in June 2014. It is a close call whether a precautionary line will suffice or the country will need to resort to a second bail-out program.
- Political cohesion and perseverance on implementation of structural reforms remain critical factors for the country's ability to avoid a second bail-out program. However, social fatigue, the fragility of the government coalition and negative constitutional court rulings pose risks to continued reform implementation.
- In our view, private sector involvement in the case of Portugal is unlikely because a) even in a conservative growth scenario the debt dynamics do not look explosive and b) it would have destabilizing consequences in the euro area sovereign bond market.

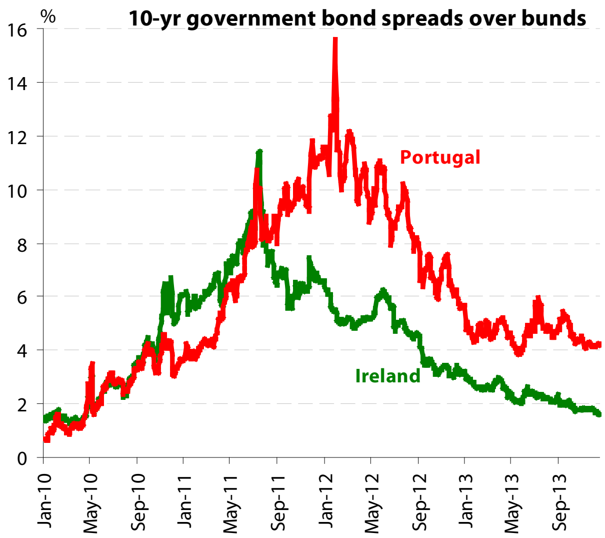
As the Portuguese financial assistance program is coming to an end in June 2014, concerns remain whether the country will be able to return to markets for regular fund raising or some form of additional financial assistance will prove necessary.

Chronic macroeconomic weaknesses eroded markets' confidence on Portugal's ability to make good on its debts, forcing the country to seek a bail-out program in April 2011. Since then, Portugal has taken considerable steps to rebalance its economy. A wide range of structural reforms have allowed Portugal to recoup competitiveness lost since the adoption of the euro. This contributed to the improvement of its current account balance, which is projected to record a surplus of 0.9% this year, a massive reduction from the peak deficit of -12.6% in 2008 and the first positive printing since 1969. Moreover, structural reforms have led to a friendlier environment for entrepreneurship. Indeed, Portugal has managed to climb 17 places on the World Bank's 'ease of doing business' ranking compared to its position in 2008 [1]. Painful fiscal consolidation efforts have resulted in a substantial reduction of the structural deficit (i.e. the deficit corrected for the economic cycle net of one-off factors), which is projected to shrink to -3.7% in 2013 from the record high since the adoption of the euro of -8.8% in 2010.

Despite the macroeconomic improvement, the country's full financial independence once the program terminates is not secured. Unlike Ireland, which graduated from its bail-out program without requesting additional financial assistance, the Portuguese economic prospects are weaker, the export sector is significantly smaller and headwinds to the economy are stronger. The gap between the degree of investors' confidence on the two economies is illustrated by the difference in long term bond yields (Figure 1). At the level of 6%, the cost of borrowing money with 10-year maturity renders outright exit to markets highly challenging.

[1] Greece has improved by 24 places, Italy has remained at the same ranking, whereas Spain and Ireland have retreated by 3 and 8 places, respectively.

Figure 1



Note: For Ireland, 10-yr and 9-yr bonds have been used.
Source: Bloomberg

In our view, the best case scenario for Portugal is to apply for some form of precautionary financial assistance provided by the ESM in order to maintain continuous access to market financing. Precautionary financial assistance may be provided in two types: Precautionary Conditioned Credit line (PCCL) and Enhanced Conditions Credit Line (ECCL). To qualify for PCCL, among others, Portugal must respect its fiscal and macroeconomic adjustment commitments, show a track record of access to private markets on reasonable terms and exhibit sustainable government debt dynamics. Otherwise, Portugal may be granted assistance through an ECCL, which entails stricter conditionality. In our view, policymakers in Portugal and creditor countries will try hard to avoid a second bail-out program due to reform fatigue and bail-out fatigue, respectively. Moreover, in view of the upcoming European Parliament elections, policymakers would be inclined to avoid criticism about the effectiveness of the rebalancing orthodoxy followed in the euro area that a second bail-out program would raise. However, given the downside risks the country is facing and its fragile debt dynamics, a full blown second bail-out program should not be excluded.

Risks to reform implementation challenge Portugal's smooth exit to markets

The predominant risk towards a smooth transition of Portugal to financial independence pertains to continued implementation of structural reforms. During the first decade of the euro, Portugal failed to rip the benefits stemming from tying its economy to a strong and stable currency. As a result, even before the crisis the Portuguese economy was mired in a low growth trajectory, averaging 1.1% annually over the period from 2002 to 2008. Keeping up the momentum of structural reforms is deemed indispensable in order to increase potential output and safeguard the sustainability of its public debt. This in turn, will boost markets' confidence in the Portuguese economy, keep borrowing costs at a sustainable level and constrain the need of a second bail-out program.

Yet, reform implementation is threatened by social fatigue, reform fatigue of a fragile government coalition and adverse constitutional court rulings on austerity measures. Last summer, reform fatigue along with obstacles to the adjustment program raised by the constitutional court decisions brought the government coalition close to collapse. Investors' fears about the country's prospects of exiting to markets resurfaced, leading to a sharp rise of government bond yields, which reached 7.5% in mid-July, compared to 5.2% in May. Looking ahead, we see three main sources of political unrest: a) negotiations of the conditions of the precautionary credit line may create centrifugal forces among political parties. As the opposition has escalated its rhetoric against the government policies, lack of cross party support on the conditionalities attached to new financial aid would undermine investors' confidence, b) a very poor performance of the ruling parties in the European Parliament elections, eroding the legitimacy of the current government coalition and c) rejection of 2014 budget measures by the constitutional court, that could derail the achievement of fiscal targets[2] and trigger another political crisis. In fact, repeated negative rulings by the constitutional court undermine the government's cohesion and limit the already constrained leeway for agreement among the government allies as rejected measures need to be replaced by alternative proposals.

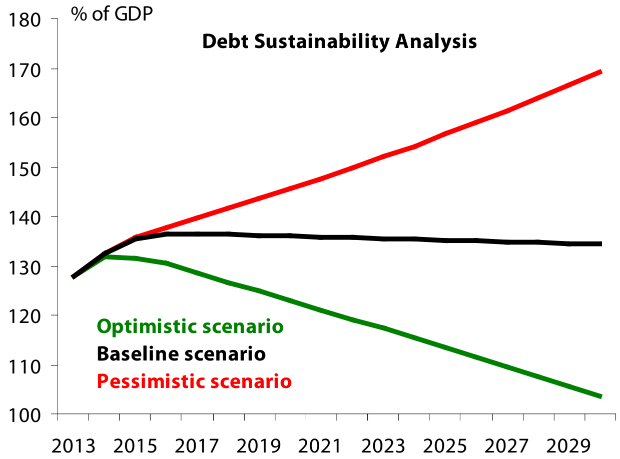
A PSI is not likely

In our view, even in the case a second bail-out proves unavoidable a debt restructuring involving losses for private investors is unlikely in the case of Portugal as long as programme implementation remains broadly on track. Our debt sustainability analysis suggests that debt dynamics do not seem precarious even under a conservative scenario (Figure 2). Assuming a moderate growth rate of real GDP at 1.5% per annum, borrowing costs at 5%, primary surplus rising to 2.2% and inflation progressively rising to 2% (Table 1), the debt to GDP ratio stabilizes at about 134%. The yield assumed is about 100bps higher compared to yield prevailed over the period 2002-2007. Annual GDP growth is half a percentage point higher than the average growth over the same period. In a more optimistic scenario where structural reforms allow real GDP growth rate to accelerate to 2%, markets lend the government at 4.5% and a primary surplus of 3% is achieved, the debt to GDP ratio embarks on a declining path, falling to below 104% by 2030. However, in a pessimistic scenario where Portugal fails to raise its potential

[2] The government has been committed to reduce the budget deficit from 5.9% in 2013 to 4% in 2014. According to the draft budget presented in October, the reduction will be achieved through measures worth €3.9bn, of which €3.2bn come from expenditure cuts.

output and its economy gets mired in a subdued growth rate equal to 1% in the years to come, debt sustainability will be unattainable, raising the risk of PSI. In the pessimistic scenario, we assumed that fiscal prudence resulting in an annual primary balance of 2% is maintained and borrowing costs mount to 5.5%, a rather optimistic assumption in such an economic context. The pessimistic scenario analysis illustrates that even more than achieving fiscal targets, perseverance on structural reforms in order to increase long term potential growth is important to preserve debt sustainability.

Figure 2



Source: Eurobank Research

Table 1
Debt Sustainability Analysis: Scenario assumptions

	GDP growth (%)	interest rate (%)	inflation (%)	primary surplus (%)
2014	0.7	5.2	0.5	0.3
	0.7	5.2	0.5	0.3
	0.7	5	1	0.3
2015	1	5.5	1	1.5
	1	5	0.5	1.7
	1.5	4.5	1.2	2.5
2016	1	5.5	1.5	2
	1.5	5	1.5	2
	2	4.5	1.5	2.5
2017	1	5.5	1.7	2
	1.5	5	1.7	2.2
	2	4.5	2	2.5
2018-2030	1	5.5	1.7	2
	1.5	5	2	2.2
	2	4.5	2	2.5

Note: Baseline scenario in black, pessimistic scenario in red, optimistic scenario in green.
Source: Eurobank research

Beyond the implications of the dynamics of the Portuguese debt itself, a haircut on private investors' government bond holdings would be avoided as it could destabilise the euro area public debt markets. European leaders have been committed that the Greek PSI was unique. If that proves not to be the case, a wave of contagious financial turmoil would most likely sweep the entire euro area. After all, if a PSI were to be decided for the Portuguese public debt which is forecasted to be below 130% of GDP in 2013, that would automatically imply that the Greek and, even more worrisomely, the Italian debt are also unsustainable.

Heavy repayment schedule ahead

A heavy debt maturing profile in 2014 and 2015 poses another risk to Portugal's ability to stand on its own feet when its program ends. According to the IGCP, the Portuguese treasury and debt management agency, state borrowing needs in 2014 amount to 25.5bn, of which 7bn will be covered by cash deposits, 7.9bn will be covered by the last EU/IMF program tranche and the rest 10.7bn need to be raised in private markets. In 2015, the country needs to raise 20.4bn. A precautionary credit line would allow the government to draw funds up to 10% of its GDP, i.e. ca. 16.8bn. In the next two years, only 0.5bn of an IMF loan comes due. Therefore a maturity extension of official financial assistance would alleviate only marginally the country's debt redemption profile in the near future.

To alleviate its funding profile, Portugal has recently performed an allegedly successful exchange offer in which bonds worth about 6.64bn maturing in 2014 and 2015 have been swapped with bonds maturing in 2017 and 2018. The cost of the new bonds is higher; however the exchange provides Portugal with some breathing space for its finances. The move is similar to the one in October 2012 when the Portuguese authorities persuaded investors to swap €3.8 billion of 1-year debt with bonds maturing in 2015 in an attempt to measure the risk perception on Portuguese debt. The positive track record of fiscal adjustment and substantial progress in structural reforms led to a material decline of borrowing costs in the first half of 2013, allowing the government to issue a 10-year bond in May 2013 at 5.67%. According to Fitch, Portugal needs to issue at least twice in the first half of 2014 in order to show a track record of access to private markets on reasonable terms and qualify for a PCCL. This is a challenging task, given that 10-year bond yields remain above 6% and the risks looming ahead.

Overall, it is a close call weather Portugal will manage to gain some degree of financial independence or it will have to resort to a second bail-out program. The final outcome depends heavily on the ability of Portuguese policymakers to preserve political stability and exhibit continued ownership of the fiscal adjustment and the structural reform program. Continued program compliance is indispensable to convince investors of the country's long term growth prospects and lure them back.

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