Euro Area

Portugal Political Crisis

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- The resignation of the leader of the government coalition's junior party CDS-PP, Paulo Portas, from his position as foreign minister, a day after the departure of the technocrat Finance Minister Vitor Gaspar, appears to have put the Portuguese government on the verge of collapse. Even if the current fracture is recomposed in the next few days, the difficult political decisions of the coming months will likely keep the risk of a coalition break-up very high. This is an unexpected development in a country where political stability and support for the EU/IMF bailout programme have been relatively more resilient than in the rest of the euro area periphery. The current crisis is apparently the result of mounting discontent against uninterrupted fiscal austerity (lasting for the past 2½ years), its failure to bring the envisaged correction in the public accounts and worse-than-expected effects on GDP growth. This has significantly eroded the government's political capital. The support for the main governing party, the conservative PSD, has been falling in opinion polls over the past year to around 25%, from the 38.7% in the 2011 elections, while the Socialist opposition party has gained and it now leads the polls by at least 10pp. The junior conservative party CDS-PP stands at 9-10%, slightly below the 11.7% of the 2011 elections. In contrast to Greece, no extremist party has gained much support at the expense of the mainstream groups. We think that the chances of snap elections have increased following recent events, but acknowledge the possibility of a bi-partisan agreement for a "unity" government, under strong European pressures to avoid the uncertainty of the ballot box. In any case, the image of a stable political framework in Portugal has been fractured.

- The relatively constructive and cooperative stance between the Portuguese authorities and the troika has probably gone too, and this poses two main challenges for Portugal. First, it increases risks of a wider budget deficit – it is less clear now if the recently-agreed to spending cuts (3% of GDP over next two years) will be implemented or renegotiated with the troika. This adds to the existing risks of further legal challenges to fresh spending cuts in front of the Constitutional Court. Second, the political turmoil reduces the chances of a smooth exit from the bailout programme (due to end in June 2014) as full market financing seems more distant in the wake of political instability and renewed debt sustainability concerns. We have argued for some time that some ESM precautionary credit line post-2014 would be necessary for Portugal, but we think the probability of a second fully-fledged bailout programme has increased because of the reduced likelihood that Portugal can regain normal market access. In turn, a greater likelihood of a second *full* programme increases the risk of some further public debt restructuring involving official creditors – and perhaps also restructuring of public debt held by private creditors.

- The contagion from the Portuguese crisis to the rest of the euro area may be more contained than in the past. However, this makes it far less likely that the ECB will be willing to activate the OTM to help Portuguese bonds in the near term.

We see three possible options to exit the current political impasse. 1) The move of the junior coalition party's leader Portas may be intended to take advantage of the government weakness to increase his party's visibility and to be seen as the key supporter of the renegotiation of the fiscal austerity measures with the troika, before returning to government. We think this may not be a very likely option – Portas said his decision was "irrevocable". Also, it may take months before such negotiations can be completed. 2) An alternative would be a "unity government" being enforced under aegis of the President of the Republic, Anibal Cavaco Silva, bringing together the two mainstream parties – the PSD and the Socialists. The Socialists were in power in 2011 at the time of the request for the bailout; but lately they have been more vocal on the need to reduce the pace of fiscal adjustment and very critical of the government's capabilities for negotiating with the troika. The Socialist leader, Antonio Seguro, said this week that a change of national leadership is warranted at this stage and stepped up his calls for early elections. 3) We think that the third option – snap elections – has become increasingly likely. This scenario may be prevented only if pressures from European policymakers on the Portuguese President of the Republic increase significantly to avoid the uncertainty of the ballot box. However, the risk of extremist parties taking power in Portugal is far less relevant than in Greece (or Italy), making the event of early elections less likely to be feared too much in European capitals.

In any case, we think the fairly cooperative relationship between Portugal and its international lenders may be compromised for good. This increases the risk of next bailout tranches being withheld (€13.4bn are still due in the programme before May 2014), although this risk is partly offset by the large cash buffers recently accumulated (some €15bn at the end of 2012 and additional €3-4bn in H1 13). This should to some extent ensure coverage of government financing for the next 12 months and hence keep the IMF relatively satisfied. However, the main problems relate to 2014, when decisions on how to deal with the post-bailout period have to be taken.

The fiscal and economic rebalancing of the economy is far from complete. It is probably only half-way through, in our view. The government deficit fell from the peak of 10.2% of GDP in 2009 to around 6.5% of GDP in the four quarters ending in Q1 13, and it is targeted to get below 3% by 2015 (more likely later than that). The primary deficit stood at 2% of GDP in 2012 and this is still probably too large to remove doubts on debt sustainability. We doubt that Portugal could stand on its own two feet and re-gain full market funding with these fiscal fundamentals (unlikely to be much different in 12-month's time) and with significantly further adjustment required.

Despite the recently-approved maturity extension of the bailout loans (by an average of 7 years, *de facto* a form of OSI), refinancing needs will remain high in the next three years. Medium to long-term debt maturing between 2014 and 2016 amounts to some €45.8bn (according to the June 2013 IMF's report), of which €38bn are government bonds. About half of the medium to long-term debt maturing in the next three years is held by foreign investors, according to the IMF estimates, probably including the ECB's holdings via the SMP programme.

We have argued for some time that Portugal probably will need some form of further restructuring of public debts, on top of the maturity extension already made on official loans. If, as seems increasingly likely, Portugal is unable to achieve full market funding at a tolerable yield in coming months, then the likelihood will grow that the country will need (and get) a full second programme rather than a lighter assistance package like a precautionary credit line. In turn, a full programme will likely involve further debt restructuring on official loans (OSI), but possibly also some contributions from private investors (PSI). The PSI could perhaps take the form of maturity extensions (perhaps also with coupon reductions) on short-dated securities as a way to limit the government's financing needs (and the international lenders' commitment) over the next few years.

We see a limited likelihood of the ECB OMT activation to cap Portuguese yields in the near term. First, it remains dubious whether Portugal has regained "full market access", despite having been able to issue a 10-year bond in May. Second, the comfortable cash position of the Portuguese government makes a funding crisis in the next 9-12 months quite unlikely, even in the event of some next tranches being withheld. Finally, and more crucially, the ECB is not in the game of firefighting domestic politics. In our view, the ECB would only be ready to use the OMT in case of relevant system risks re-igniting euro break-up fears. For the time being, Portuguese events are unlikely to have such a knock-on effect on the rest of the euro area.

Appendix A-1

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