

Economic Research Note

Portuguese second package will not include PSI

- The are multiple reasons for Portugal's underperformance; debt sustainability is a key challenge
- But, the government is putting in a good faith effort, making a near-term debt restructuring unlikely

The recent Portuguese sovereign bond market underperformance is striking in the light of the peripheral bond market improvement seen since the launch of the ECB's LTRO at the end of last year. The lack of meaningful news of late means that the drivers of the underperformance are not entirely clear. But, there are various reasons why markets may be distinguishing Portugal from other peripherals. First, though not to the same degree, Portugal suffers from many of the problems that Greece suffers from: a high level of debt, a wide deficit, and structurally weak growth. Second, there were clear signs that Portuguese growth was downshifting at the end of last year, providing confirmation that the economy is likely to have the weakest macro performance in the Euro area after Greece this year. Third, while Portugal likely more than met its deficit target last year, it did so through large one-off pension fund transfers to the state. Fourth, the sovereign's recent S&P downgrade to junk status may have sparked an exit from the market by some investors.

A key question in investors' minds appears to be whether Portugal is next in line after Greece for a near-term debt restructuring. The challenges to Portuguese debt sustainability are clearly significant. Whether or not the sovereign can make the fiscal journey without a debt haircut, in our view, depends on whether there is willingness on the part of European policymakers to provide subsidized liquidity to the sovereign for an extended period, and whether there is enough political and social commitment in Portugal to drive the adjustment. Judging by recent developments, there is reason to be relatively optimistic on both these fronts, at least in the near term.

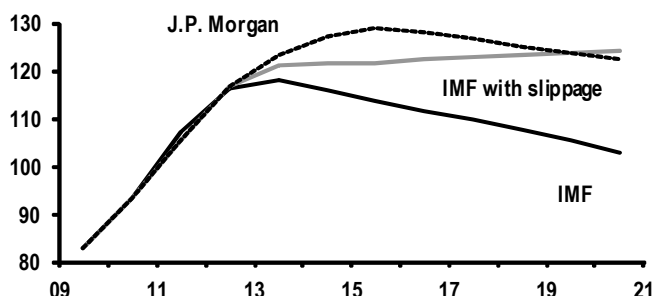
What is wrong in Portugal

Looking more closely at each reason why markets may be punishing Portugal relative to other peripherals:

- Sovereigns in the Euro area periphery can be said to suffer from one or more key maladies: large deficits, high debt, and weak competitiveness and growth potential. While not to the same extent as Greece, Portugal suffers

Portuguese debt dynamics are challenging

% GDP ("IMF with slippage" entails 1% permanent miss on growth and pr. bal.)



Key macro and fiscal projections

% GDP, unless otherwise indicated

		2010	2011	2012	2013	2014
IMF (Dec 2011)	Real GDP, %oya	1.4	-1.6	-3.0	0.7	2.4
	Budget balance	-9.8	-5.8	-4.5	-2.9	-2.2
	Primary balance	-6.8	-1.6	0.5	2.2	3.0
	Gross debt	93.3	107.2	116.3	118.1	116.0
J.P. Morgan	Real GDP, %oya	1.4	-1.5	-4.2	-1.2	-0.3
	Budget balance	-9.8	-4.2*	-5.4	-4.3	-3.9
	Primary balance	-6.8	0.0*	-0.3	1.0	1.8
	Gross debt	93.3	105.5*	116.9	123.3	127.3

* The figures include the effect of the pension fund transfer to the government (worth around 3.5%-pts of GDP).

from all three of these maladies. Debt last year was likely above 105% of GDP, while the deficit (excluding the effect of one-off factors) was likely above 7%. At the same time, Portugal's competitiveness clearly deteriorated over the past decade, as the economy had the poorest growth performance in the region after Italy.

- After a slightly better-than-expected growth performance last year, when GDP likely contracted 1.5%, Portugal looks set to experience a deeper recession this year. Confirmations of a step down in activity came more clearly in 4Q11, when IP likely declined 6% or so, retail sales fell 25% or so, exports slowed, and business and consumer surveys turned further south. With a very ambitious consolidation plan and significant structural challenges, Portugal is likely to be the worst-performing economy in the Euro area after Greece this year. Our own forecast suggests that GDP will contract 4.2%, more than the government assumes, posing a clear challenge to the fiscal plan.
- Even though the government estimates that the deficit last year may turn out to be around 4% of GDP, 2%-pts or so narrower than target, this is due to a one-off transfer of banks' pension funds to the government late last year. Excluding this transfer, the deficit would have ended the year at close to 7.5% of GDP, 1.5%-pts wider than target. Growth was a little better than expected, and the underlying deficit likely reflects some implementa-

tion failures. Strikingly, Portugal resorted to a similar measure in 2010 to lower its deficit (a pension transfer from Portugal Telecom that time), which raises questions regarding the sovereign's credibility in permanently reducing the deficit.

- The S&P downgrade of Portugal to junk status has pushed the sovereign out of some bond market indices, and may have accelerated investors' exit from the market. Evidence of that can be seen in Portugal's under-performance on the day of the downgrade (which contrasts with the absence of a sell-off in Italian and Spanish bonds on the day, despite their own downgrades).

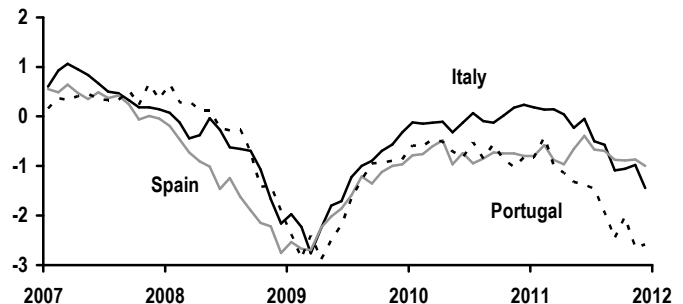
Some reasons to be more sanguine

There are, however, also reasons to be more sanguine about Portugal:

- Even though the nearly 6%-pt deficit improvement (from 9.8% of GDP to around 4%) last year was helped by one-off revenues, the presence of offsetting one-off expenditures (costs related to state-owned enterprises and a failed bank) and the presence of one-off revenues in the prior year mean that a decent adjustment in the underlying budget position was achieved. The exact adjustment to be made for one-offs in 2010 and 2011 is unclear, but the government assesses that the structural budget balance improved 4%-5%-pts of GDP in 2011.
- Despite slipping on its deficit target in an underlying sense, Portugal made progress on the structural side. Key legislation has been passed to increase labor market flexibility, reform revenue administration, liberalize the telecommunications sector, and improve competition. The recent Budget also includes significant cuts in public sector wages and employment. The IMF's December report on Portugal commends the progress made on structural reform, which contrasts with the Fund's assessment about Greece in this regard.
- There are signs of strong political and social consensus behind government actions. The tough Budget package put forth by the administration late last year received 90% approval in parliament, while labor union leaders appear to be adopting a cooperative attitude with the newly elected right-wing government.
- Behind the 1.5% or so decline in GDP last year was robust growth in exports (up more than 10% on average in the first three quarters of the year) and a collapse in domestic final demand (down 6% on average over this period). The solid export performance is encouraging given con-

EC economic sentiment survey

Standard deviations from the mean (calculated from 1999)



cerns about competitiveness. Coupled with the fall in domestic spending and an improving current account position, it also suggests that Portugal is making progress toward reducing its significant external imbalances.

How about a near-term debt restructuring

In order to achieve a position of debt sustainability, Portugal needs to make a long fiscal journey. The sovereign needs not only to close its primary deficit—which was probably close to 3% of GDP last year, excluding the effect of one-off items—but also to move to a meaningful primary surplus (3%-4% of GDP at least) to achieve gradual debt reduction ahead. Such an adjustment is feasible under two conditions. First, the sovereign needs to have access to liquidity at reasonable borrowing rates for an extended period (which likely calls for lasting support by European policymakers to keep the sovereign out of the market, or intervening in markets to keep borrowing rates low). Second, the government needs to remain committed to the adjustment, with the social environment remaining supportive. The political and social consensus behind the government's program, and the fact that Coelho's administration is perceived to be putting in a good faith effort by the Troika, suggests that there are reasons to be sanguine on both these points for now. Contagion created by the Greek debt restructuring also suggests that neither Portugal nor European authorities are likely to view PSI as an attractive way forward in the near term.

A fairly imminent issue is the extension of the liquidity package provided to Portugal. This package expires around the middle of 2013, and a decision on whether to extend it has to be made by this summer. Both the Troika and the Portuguese authorities say that they are planning a return of the sovereign to the markets next year. We have serious doubts about that happening but, as long as Portugal continues to put in a good faith effort, there should be no problems with the package being extended. This package is unlikely to include PSI as part of the debt reduction plan.