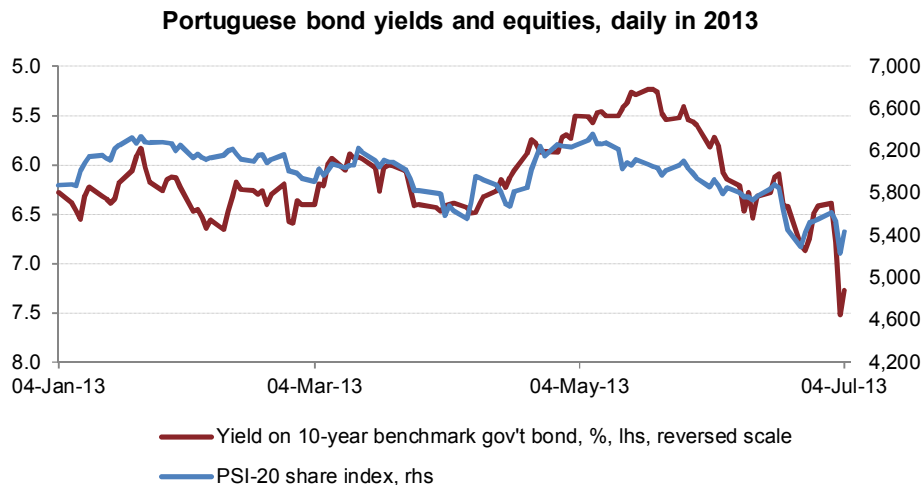


Return of the euro crisis – not for the last time

- **Portugal was the troika’s star pupil – doing everything right**
- **Even so, the country failed to achieve its fiscal targets**
- **Recent turmoil highlights the risk of political and social tensions becoming unacceptable**

In July 2012 the ECB President Mario Draghi vowed to do “whatever it takes” to save the euro. This statement – later codified into the ECB’s plans for Outright Monetary transactions (OMT), proved a turning point in markets’ view of the likelihood of a euro area (EA) breakup. Even the Cyprus crisis in early 2013 failed to shake this conviction – despite Cyprus coming close to the edge when its parliament rejected the first bail-out proposal. But this does not mean that the euro crisis has gone away. The main danger for the time being is that – in spite of austerity policies being eased – social and political tensions in the single currency, notably in its southern periphery, rise to the point of being unacceptable.



The events in Portugal this week July highlight that risk. To recapitulate, on 1st July Finance Minister Vítor Gaspar resigned because of the government’s failure to reach budget targets set by the European Commission. The next day Foreign Minister Paulo Portas, leader of one of the two coalition parties also resigned. He disagreed with the Prime Minister’s proposed replacement for Mr Gaspar who intended to carry on the resigned minister’s program. Mr Portas would have preferred to move policy away from austerity and more towards a focus on growth and investment. He did not (yet?) pull his party out of the government and there are talks trying to resolve his disagreement with the Prime Minister. Nevertheless, markets took fright: the yield on the 10-year benchmark government bond closed at 7.52% on 3rd July, having been at 5.23% in mid-May and around 6.1% in mid-June. The PSI-20 stock market index closed at 5,236.49, down 18% from a recent peak on 7th May 2013 and down 7% from the beginning of the week. Both bonds and equities recovered the next day, partly on reports that the government crisis was being

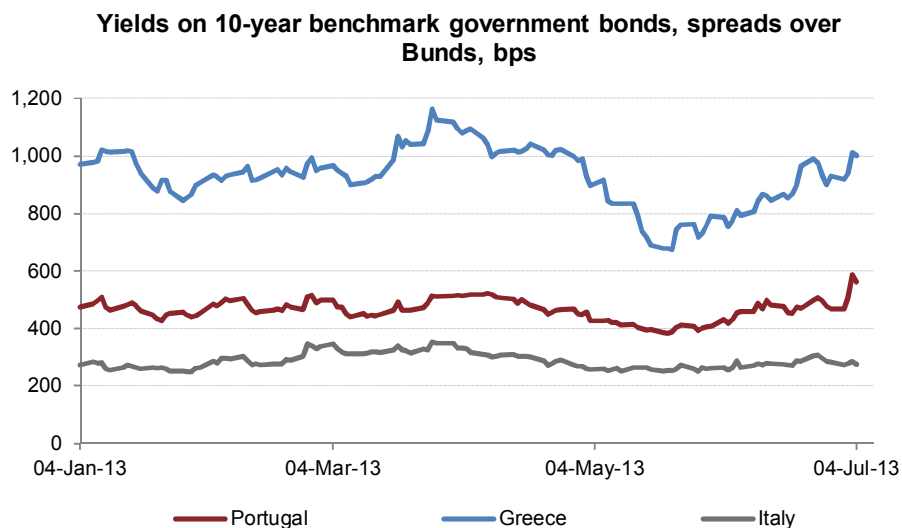
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solved; but, at 7.27% for bond yields and 5,431.6 for the PSI-20, asset prices are still down from their late spring highs and also compared with the beginning of the year.

While Portugal – like Greece and Cyprus – is a small country (its GDP is 1.7% of the total EA), its importance exceeds its size. Portugal has been very much the star pupil of the troika (the EU, ECB and IMF), uncomplainingly doing everything asked of it. Yet even so, its debt is now forecast by the OECD to peak at 130% of GDP in 2015. This compares with the most recent troika forecast, which was for the debt/GDP ratio to peak at 123.7% in 2014.

In addition to this failure to reach targets in spite of doing everything ‘right’ – which in itself raises a question mark over the policies prescribed – we now also have a senior government minister and party leader speaking out against austerity: in other words, a sign of the rising social and political tension which ultimately could threaten the survival of the EA in its current form.



So far, there has been little contagion from Portugal to other EA markets. Italian and Greek bond yields have risen slightly, but not unduly (there is a more long-term rise in Greek spreads vis-à-vis Bunds, but that is not connected to Portuguese developments). This is a sign that Mr Draghi’s promise is so far working. However, there is a government crisis in Greece, where one party (DIMAR) has left the coalition on 21st June, leaving the government with 153 seats out of 300. In addition, Greece may lose out on further tranches from the troika as it seems that the country has not complied with all the conditions of its bail-out agreement. The President of Cyprus has asked for the terms of his country’s bail-out to be renegotiated because of the pain they inflict on the economy. And the future of the Italian government is (as always?) uncertain. A flare-up in any of these could easily trigger contagion elsewhere, potentially forcing the OMT plans to be tested.

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Even if this does not happen, what is the outlook for Portugal? Realistically, there really only seem to be two possibilities for near-term economic policy (leaving aside what happens to the government). Either austerity policies continue, or there is a further easing of Portugal's bail-out terms. Continued austerity is unlikely to work – to repeat, Portugal has done everything asked of it and still not managed to achieve the targets set. Continued austerity without tangible results will only lead to the political crisis recurring some time down the line. Hence easier terms are the most likely outcome, most likely in terms of extending the time-table for reaching budget deficit and gross debt targets. But there is a problem here too; reforms are rarely, if ever, undertaken without a crisis to spur them on. Keep extending the targets for, eg, government debt or the budget deficit, and you ultimately run the risk of the period being so long that it becomes meaningless.

Prior to the Portuguese government crisis, recent data had implied that the EA economy might now have reached the bottom. Numbers (eg, PMIs) were weak but slightly better than expected. If you believe the EA will hold together in spite of all, this might be an opportunity to buy on the dip. If, on the other hand, you believe that the crises will reoccur – and this seems more likely – the message to stay away from EA periphery assets is becoming ever clearer.

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