



Economic Flash!

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Trouble in Portugal – and More Pain to Come

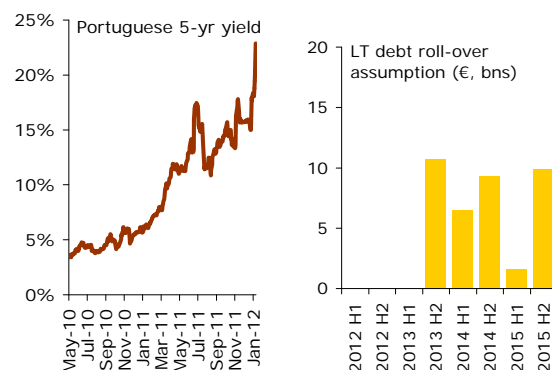
Portuguese funding costs, while settled today, have been soaring in recent weeks—with the 5-year yield at 22% and rising. The nation that received a €78 bn bailout less than a year ago will likely require another cash injection from eurozone partners as its economy continues to contract, and as it finds itself shut out of debt markets ahead of plans to tap private funding in 2013. With Greece’s second bailout requiring what looks now like a 70% net present-value loss for private bondholders, Portuguese sovereign debt has recently plunged in value, as investors there feared being next in the haircut line.

Portugal’s Funding Crunch

The Portuguese government hasn’t worked out how it will fund itself come mid-2013. The existing plan (as per the current bailout deal) is that Portugal will begin to tap long-term debt markets to roll over maturing debt (Chart 1), as it gradually transitions to fiscal self-sustainability. However, with yields soaring, Portugal remains shut out of long-term funding markets, and will need to stay hooked up to the bailout feeding tube for longer.

The IMF, one of the lenders in Portugal’s existing rescue deal, has in the past required its debtors to have no funding gap over the coming one-year period in order to release funds. Thus, the IMF’s bailout disbursements to Portugal (with €14 bn still set to be paid through 2014) could hit a wall come mid-2012 if the sovereign hasn’t secured funding sources for its needs beyond mid-2013. With Portuguese bond yields continuing to spiral out of control, another bailout from European peers is the clearest option.

Chart 1
Soaring Yields Derail Portugal’s Plans to Tap Debt Markets in Mid-2013



Source: Bloomberg, CIBC

Debt Restructuring Risk

The European Council clearly stated on December 9th, 2011 that negotiated private sector losses were a unique case for Greece alone. Indeed, Portugal’s debt burden, at 110% gross debt-to-GDP, is much more manageable than Greece’s near-200% debt load, limiting the need for aggressive haircuts on Portuguese debt. However, Portuguese bonds continue to plunge in value on concerns that Greece may no longer be viewed as a unique case by European leaders. As Portugal remains shut out of funding markets, all the while struggling under the burden of sharp austerity, the nation’s economic and fiscal dynamics could begin to more closely mirror those of Greece.

The relatively small size of Portugal's debt market should limit the impact of contagion stemming from any potential write-down of its sovereign debt. While foreign European banks' sovereign exposures to Portugal nearly match exposures to the larger Greek government (Chart 2), taken in context, those exposures are quite small when compared to European banks' claims on other recently troubled sovereigns such as Italy (Chart 2). Looking at the exposures to Portugal, it is German, Spanish and French banks that are the most acutely exposed, in that order. While it may be surprising that Germany's exposures are larger than those of say, Spain, the latter has much more elevated claims on Portugal's non-bank private sector (Chart 3). That suggests that a continued weakening in Portugal's economic activity would weigh on other eurozone nations through not just financial, but also economic channels.

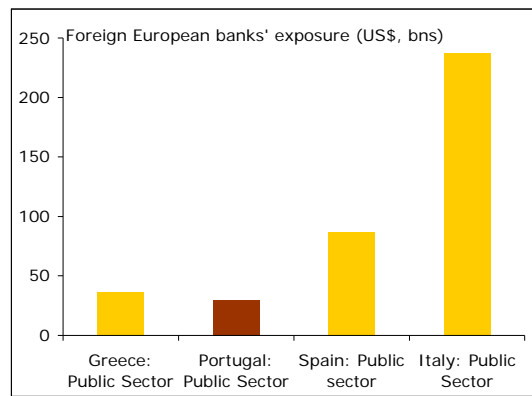
Portuguese Fundamentals Deteriorate

In 2012, Portugal faces tough austerity measures that include increases in value-added taxes and cuts to public sector pay, in some cases up to 25% of salaries. But that's just adding to an already acute economic deterioration, as even in 2011, a sharp worsening in the household sector was clearly visible with consumption activity in a free-fall (Chart 4), and joblessness soaring dangerously close to what appears to be a now optimistic official 2012 target of 13.8%. With an already deteriorating economy, and per-capita GDP that ranks even below that of Greece, it is increasingly politically challenging to continue extracting austerity from an already economically burdened population. And even with crippling public sector cuts contributing to a contraction of around 4% GDP this year, the sovereign is still expected to run deficits through 2015—pointing to an extended timetable for fiscal weakness.

Implications

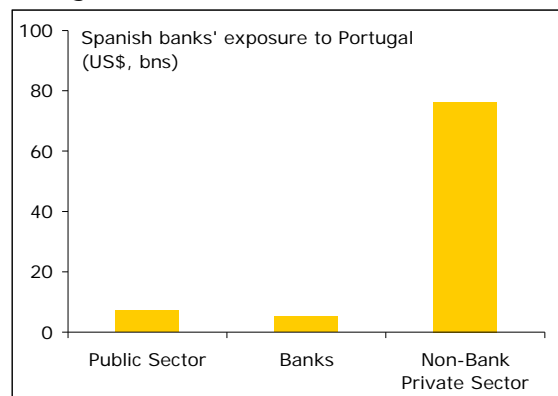
Even with the ECB's infusion of liquidity into the system in December, and expectations for additional cheap funding at the upcoming Feb 29th 3-year LTRO, Portuguese bonds have continued to plunge as investors recognize the risk that a "voluntary" debt write-down may be on the way. The relatively small size of the Portuguese debt market limits the scope for contagion associated with any negotiated bondholder losses. However, confidence in the euro could still be rattled, as any additional bailout for Portugal with associated bondholder losses would dent the credibility of authorities that had previously assured markets that Greece was a unique case. As weak data on the Portuguese economy rolls in through mid-year, expect the euro to feel further downward pressure.

Chart 2
Foreign European Banks' Exposure to Portuguese Sovereign Relatively Limited



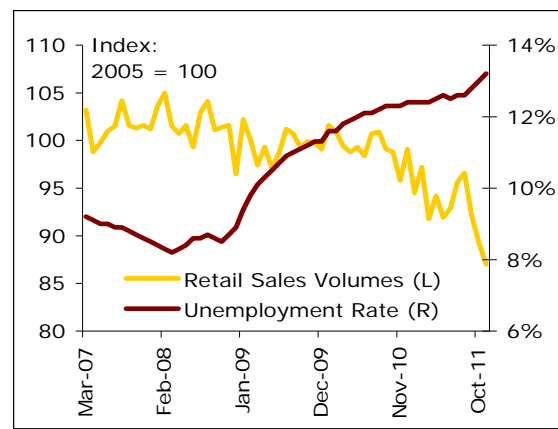
Source: BIS, Bloomberg, CIBC

Chart 3
Spanish Banks Primarily Exposed to Portugal's Private, not Public Sector



Source: BIS, CIBC

Chart 4
Portuguese Economy Deteriorates



Source: Eurostat, Bloomberg, CIBC

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