

Sujet: Est-ce que la Portugal est le prochain Grèce ? / is Portugal the next Greece ?

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IS PORTUGAL THE NEXT SHOE TO DROP? SPAIN: IN THE BULL RING

Dear Clients,

Over the past few months the economic problems of Portugal and Spain have been thrown into the spotlight due to the rising vulnerability of Greece. The concerns are not without merit. Budget deficits are way too high and both economies have relatively weak export bases to grow themselves out of their difficulties. However, there are important differences from Greece that are being overlooked. The fiscal deficit plans are more coherent, there is a history of delivery on tax reforms and the huge immigration into Spain could yet be a boon.

The following reports published originally by our European Investment Strategy service explore these themes in more detail. We hope you will find them of interest. Later this week we plan on completing our review of the more susceptible economies in Southern Europe with a *Special Report* on Italy. Stay tuned.

Best Regards,

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CONCLUSIONS

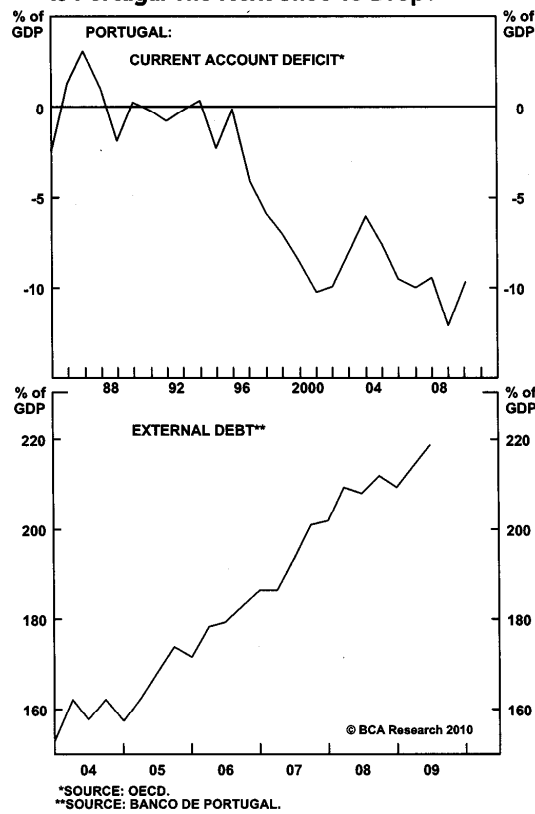
- Portugal is unlikely to default, but the resolve of its policymakers will be severely tested.
- Portugal is nothing like Greece. It has an impressive deficit reduction record, is not in a debt trap and its deficit-reduction plan appears both reasonable and achievable.
- Real bond yields are attractive both in historical and relative terms, yet debt and deficits are either inline or below peer levels.
- The consensus is too bearish on Portuguese growth. The economy is accelerating, it did not suffer from a housing bubble and structural reforms are bolstering productivity.

See pages 8, 9 and 10 for a full summary of views and positions.

There is little doubt that if Portugal was not part of the European Monetary Union, it would have defaulted a long time ago. Traditional sovereign risk metrics such as external debt/GDP are well above levels that precipitated the Latin American debt crisis in the 1980s. And its current account deficit is more than triple the 3% ceiling deemed unsustainable in the 1990s Asian meltdown (Chart 1). So why has Portugal not defaulted yet? The answer is as much a political as an economic issue.

Portugal is well aware of the benefits of being in the euro area and will do everything in its power to

CHART 1
Is Portugal The Next Shoe To Drop?



*SOURCE: OECD.
**SOURCE: BANCO DE PORTUGAL.

remain so. Euro adoption has made the type of currency crisis that preceded over 85% of sovereign defaults since the early 1970s extremely unlikely. As a result, Portugal is in a similar situation as to a U.S. state, none of which to our recollection has ever defaulted, in that it has fiscal but not monetary or currency authority.

It is also not in the interest of the European Union (EU) to allow a default or euro break-up. At less than 2% of euro zone GDP, the cost of paying off Portugal's entire debt is tiny, and pales in comparison to the potential damage a bankruptcy and the ensuing domino effect would inflict on euro area banks. Note that the EU helped bail out Hungary, Romania and Estonia on similar contagion fears – and none of these countries were even part of the euro zone. That said, if public assistance is provided to Greece then it should include punitive sanctions so as not to decrease the incentive for Portugal, Italy and Spain to pass tough austerity measures on their own.

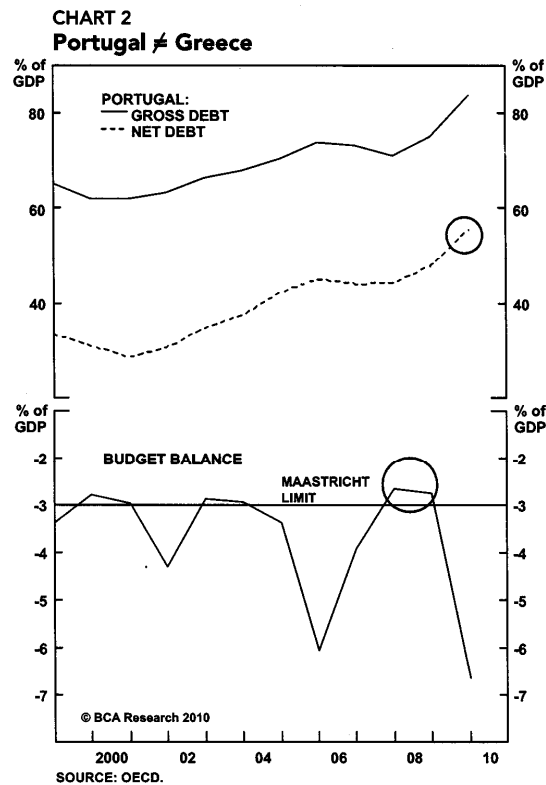
Portugal ≠ Greece

There is a world of difference between the Greek and Portuguese situations:

■ **Size of problem** While public sector debt in both countries is excessive, Greece is perilously close to being in a debt trap. Its debt is expected to exceed 100% of GDP and interest rates are well above the long-term growth rate. Accordingly, it will be extremely difficult for Greece to rapidly reduce its deficit, since doing so would risk forcing the economy into recession. In contrast, Portuguese *net debt* is only 56% of GDP (Chart 2).

■ **Credibility** Unreliable data gives Greece a credibility problem. And it has not had a budget deficit below the Maastricht guidelines since 1980. Quite the opposite is true in Portugal, which has a very impressive deficit reduction record.

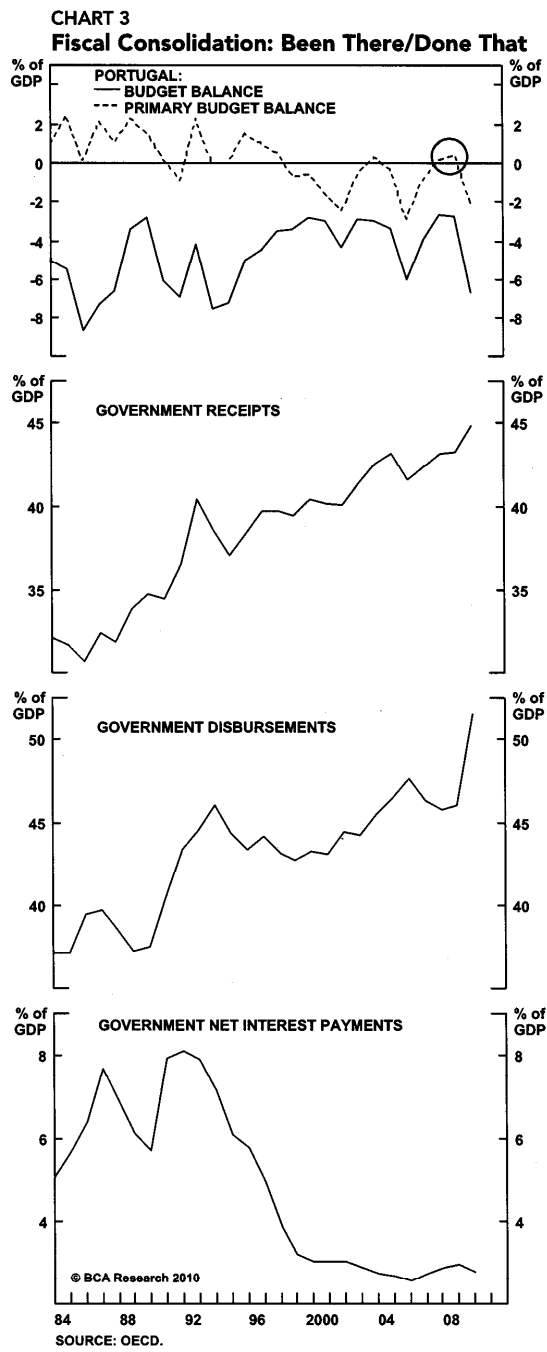
The current Portuguese Prime Minister (ironically named Socrates) reduced the deficit from 6.8% in 2005 to less than 3% in 2007 and 2008. He also attained a primary surplus in those years, with deficits consistently below expectations. Moreover, this was accomplished by making politically unpopular



decisions such as reducing the size of the public sector, freezing wages, dramatically cutting benefits for government employees, and breaking an electoral promise by raising the VAT tax (Chart 3 on page 3).

■ **Resolution potential** Unlike Greece, where the game plan seems to change daily, the Portuguese plan has reasonable assumptions and appears achievable. Moreover, Finance Minister Fernando Teixeira Dos Santos recently implied that additional cuts are likely.

Overall, the EU goal of achieving a 3% deficit by 2013 seems feasible. Public sector wages can be decreased by an additional 3% of GDP to bring them in line with the EU average. If the wage freeze coupled with attrition and a cyclical rebound in tax payments is not enough to hit the EU target, then



the VAT tax can always be returned to its former level. And the wide gap between net and gross debt implies that privatization can be used to dramatically reduce debt levels.

Political risk is a wildcard. The current administration does not have a majority, and few minority governments have lasted their full four-year term. Still, recent polls indicate that 75% of the populace is behind the government's belt-tightening plans, and the right wing opposition party has agreed to abstain from voting on the budget (due by March 12th), ensuring its passage if it stays in its current form.