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Portugal – Political stability in the short term, challenges ahead

The three main Portuguese political parties did not reach an agreement on the President of the Republic's call for a "national salvation" pact. **The failure to reach a cross party agreement is unfortunate but political stability is likely in the short term.**

In the next few weeks, the coalition has vowed to outline its economic plans until 2015, the end of its term, to parliament and call a confidence vote in those policies, which, in our view it is likely to win.

The next EU/IMF review will be the first key test for the unity of the reshuffled coalition. It appears likely that the government will, at this time, ask for another change in the deficit targets.

Negotiations on a likely second aid programme should start in a few months and should shape Portugal's political landscape in the medium term, we believe. **Risks of early elections would increase as a result.** In that scenario, the PSD and the Socialist Party would most likely govern together, possibly with the CDS-PP.

Portugal is more likely to be granted a credit line but risks of a fully-fledged programme have clearly increased, in our view.

We continue to believe that forced 'Private Sector Involvement' (PSI) is unlikely given that the economic and political costs would exceed any expected gains. Under our base case scenario, **we don't foresee any nominal haircut on Portuguese bonds but a voluntary rescheduling of private bonds is a possibility.**

Political stability in the short term, challenges ahead

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The three main Portuguese political parties did not reach an agreement on the President of the Republic's call for a "national salvation" pact. The latter foresaw a cross party agreement to continue the implementation of the EU/IMF programme while opening the way for early elections next year (instead of H2 2015). It appears that the parties could not find an agreement on the reform of the public sector envisaged under the EU/IMF programme.

The failure to reach a cross party agreement is unfortunate... An agreement would have officially reinforced the country's commitment towards the EU/IMF requirements and most importantly, reduced the political risks associated with a likely second financial support programme – credit line or full-fledged bailout. However, the political costs associated with the responsibility to reduce the public sector seemed too elevated for the Socialist Party to enter into this "national salvation" pact.

…but political stability is warranted in the short term. The President of the Republic decided, as a second best outcome, to maintain the current coalition in power, and to not call for early elections. The coalition partners (PSD/CDS-PP) reunited after the leader of the junior party, Mr. Portas, was appointed deputy prime minister and a motion of confidence on the government was easily defeated last week (all PSD/CDS-PP MPs voted against it).

In the next few weeks, the coalition has vowed to outline its economic plans until the end of its term to parliament and call a confidence vote in those policies, which it is likely to win. Recent statements by the two coalition partners indicate a readiness to adhere to the EU/IMF programme but the ability of the government to push through tough measures may have been weakened as a result of the political crisis.

Exhibit 1: Chronology of the Portuguese political crisis

01-Jul	Resignation of Mr. Gaspar as Fin. Min.
01-Jul	PM Passos Coelho (PSD) appoints Ms. Alburquerque as new Fin. Min.
02-Jul	Mr. Portas, leader of the junior coalition party (CDS-PP), unhappy about the choice decides to resign, opening the door for early elections
02-Jul	PM Passos Coelho refuses Mr. Portas's resignation
03-Jul	The CDS-PP asks Mr. Portas to remain in government
06-Jul	Compromise found between PSD and CDS-PP (Mr. Portas appointed deputy PM)
10-Jul	The President of the Republic does not approve the reshuffling and calls for a national salvation pact between the three main political parties
13-Jul	Cross party talks starts
18-Jul	The coalition government survives a motion of confidence tabled by a small party
19-Jul	Cross party talks ends without any deal
21-Jul	The President of the Republic finally decides to maintain the government in power
?	The government presents its economic plans until 2015 accompanied with a confidence vote

Source: Credit Suisse

The next EU/IMF review will be a key test for the unity of the reshuffled coalition. The 8th and 9th review of the EU/IMF programme will be combined and held at the end of August/ beginning of September, when local elections' campaigns take place. The implementation of the reform of the state is the main programme requirement on the agenda. Spending cuts worth €4.7bn (2.8% of GDP) notably targeting pensions, public sector employees and the social safety net need to be introduced for the 2014-15 period.

It appears likely that the coalition will, at this time, ask for another change in the deficit targets. An agreement by Portugal's international creditors on a slower fiscal adjustment path would be a welcome move when it comes to the stability of the government. However, the €78bn aid programme is constrained by elevated government debt (between 120% and 130% of GDP) and little extra cash remaining to give Portugal more time to adjust its fiscal position. As such, an adjustment of the fiscal targets could be difficult to obtain for Portugal. Such considerations will be taken into account when negotiating a likely second aid programme.

Negotiations on a likely second aid programme should start in a few months... A second programme would most likely be formally approved after the German elections (September 22) but negotiations could actually start at the next review given the IMF requirement for the programme to be fully funded over the next 12 months to disburse its financial aid. *Diario Economico* reported that a second programme would be decided in November, during the tenth EU/IMF review.

…and should shape Portugal's political landscape in the medium term. A second programme could weaken the coalition and reduce its incentive to continue governing until 2015 while international creditors are likely to call on all parties to back another programme from its start: early elections are still possible. In that scenario, the PSD and the Socialist Party would govern together, possibly with the CDS-PP, in our view.

The form of a second aid programme should also influence political developments: the more policy conditions attached (e.g. full-fledged programme versus a credit line), the more likely early elections are.

Credit line still more likely than a full-fledged programme

We continue to believe that Portugal is more likely to be granted a credit line than a full-fledged programme but risks have clearly increased.

As we wrote in the past, an increase in the stock of T-bills, the potential usage of €6.4bn left in the banks' recapitalisation fund (increasing risks of potential banks bail-in), the recent €4bn's increase in the amount the state's reserve pension fund can invest in government bonds and potential bond market operations should provide some room for manoeuvre when accompanied with a €10bn credit line, for example. Finally, given the smaller amount a credit line entails versus a full-fledged programme, political costs would be less important both for core Europe and Portugal.

An ESM credit line would not push the ECB to intervene on the secondary market in the first stage but market probabilities of ECB interventions would increase and yield could go down as a result, we believe.

No forced PSI

We have already discussed the pros and cons of PSI (here and here), and come to the conclusion that **PSI is unlikely given that the economic and political costs would exceed any expected gains.**

The decision to PSI bondholders would notably depend on:

- The size of the financial envelope the EU would be willing to provide under a second programme
- The IMF's debt sustainability analysis given the size of the financial envelope
- The willingness of the EU to keep the IMF in a second programme
- The prospects of Portugal's return to the market
- The expected debt reduction PSI would bring about and who holds the debt
- The estimated costs for the financial stability of the eurozone and impact on bigger countries like Spain and Italy.

Taking those into account, **we continue to think there would be no nominal haircuts but a voluntary rescheduling of private bonds would be a possibility.** Only if confidence and activity were to deteriorate significantly from here (which is not the case at the moment), would the risk of nominal haircut increase, we believe.

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