STOPPING THE ROT?
The cost of a Portuguese bail-out and why it is better to restructure

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Executive summary:

- Portugal is getting ever closer to asking for a bail-out. Following the resignation of Prime Minister José Sócrates, after a series of austerity measures were voted down by Parliament, Portugal is now without a permanent government. Due to constitutional rules an election is not expected until the beginning of June.
- In 2011, the country needs to refinance 25% of its national wealth – in relative terms, this is even more than Greece. The country's borrowing cost has been above 7% for 43 consecutive days. Greece and Ireland lasted 13 and 15 days respectively at these kinds of rates before asking for a bail-out.
- We estimate that a bail-out package for Portugal would need to be at least €70 billion. This should allow Portugal to cover all bond repayments as well as any government deficits for three years.
- However, a bail-out is unlikely to solve any of Portugal's fundamental problems. Both Ireland and Greece are already looking to renegotiate their bail-out terms. This illustrates that short term loans are simply not sufficient.
- Portugal's cost competitiveness relative to Germany has decreased by 21% since the introduction of the euro. An increase in ECB interest rates, which is widely expected next month, will also lead to a decrease in the availability of credit and domestic demand in Portugal. This could cause Portuguese GDP – already estimated to shrink by 1.4% in 2011– to contract further.
- Although we expect a bail-out, we believe a more viable solution would be to restructure some of Portugal's debt. In the long run this may prove cheaper despite a larger initial cost, since, unlike in the case of a bail-out, it would cut Portugal's debt rather than increase it. It would also reduce the burden on taxpayers, instead transferring more of it to investors. Crucially, the longer Portugal waits, the costlier a restructuring will be for the country, since its debt is expected to continue to build up over the next three years.
- In order for a restructuring not to spread contagion to Spain, it would be best to combine it with a limited bail-out, which would involve smaller contributions from member states, since more of the cost is borne by investors. Despite not having a veto, the UK should look to make its participation in a bail-out conditional on a restructuring.
- The hope is that Portugal will use the cash and breathing space, freed up through a restructuring, to invest wisely in its own economy, including pushing through more economic reforms. However, the country will still be stuck with an over-valued currency, and the unanswered question of whether it can ever become competitive as long as it shares a currency with radically stronger economies such as Germany.

1 PORTUGAL IS ALREADY ON LIFE SUPPORT

Although the Portuguese government continues to deny that a bail-out will be needed, all figures suggest that Portugal is teetering on the brink. The problems facing Portugal also help to demonstrate why many of the proposals agreed at the EU summit on 24 – 25 March, will fail to solve the issues facing the eurozone.

In recent weeks the Portuguese cost of borrowing has continued to top 7% and reached a record high of 8.07%.[1]

Portugal has seen a growing political crisis over the new austerity measures tabled by the government, which five of the country's opposition parties voted down in Parliament on 23 March, leading to the Portuguese Prime Minister José Socrates' resignation. This has thrown up a number of questions, including whether it is possible for Portugal to seek a bail-out without a permanent government in place. The Portuguese constitution stipulates that, after the dissolution of Parliament, there must be a 55 day break until an election can be held. Therefore, an election is not expected to take place until the beginning of June, meaning a caretaker government will be in place until then.

The figures suggest that it is likely that Portugal will be unable to cover its financing needs this year or next year (see the table below).

	2011	
	€ billions	% of GDP
GDP	157	100
Total Debt	129.4	82.4
Budget Deficit	11.8	7.5
Long Term Debt Maturing	9.5	6.05
Short Term Debt Maturing	18.1	11.5
Total Refinancing	39.4	25.1

Source: IGCP Government Debt Monthly Bulletin for January 2011

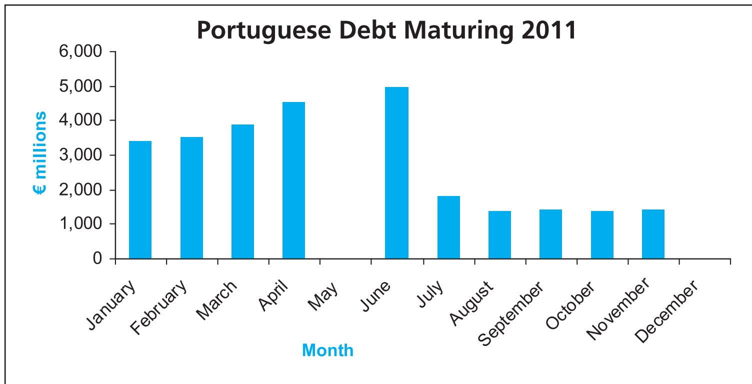
Portugal needs to refinance 25% of its national wealth in 2011: Portugal's government debt is set to reach €129.4 billion this year, giving a debt to GDP ratio of 82.4%. This is clearly not as high as that seen in Greece or Ireland, but Portugal's borrowing costs are skyrocketing.

Its ten year borrowing cost has been above 7% - the threshold widely accepted as being unsustainable - for 43 consecutive days. To put this in context, Greece and Ireland lasted 13 and 15 days respectively at these kinds of rates before asking for a bail-out.

In total, Portugal will have to raise a staggering €39.4 billion this year – equivalent to 25% of the country's national wealth (see table).[2] In relative terms, this is even higher than our estimation of Greece's refinancing cost, which stands at around 23.7% of GDP in 2011.

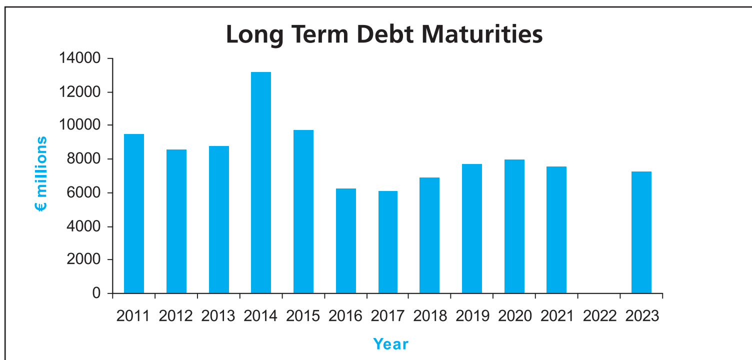
1 The cost of borrowing here refers to the interest rate paid on 10yr government bonds, this will be the case for the rest of the briefing unless otherwise specified.

2 Portugal has €9.5 billion in bonds maturing in April and June. However, it also needs to pay back €18.1 billion in short term treasury bills. This gives a total cost of €27.6 for debt maturing in 2011. Combining this with the expected deficit for the year takes it to 25.1% of GDP.



Source: IGCP Government Debt Monthly Bulletin for January 2011

Portugal also has some tough refinancing targets in the years ahead – with 2014 being a crucial year. It is possible that Portugal could continue to roll over its short term treasury bills.[3] However, the cost of doing this is huge and is merely delaying the problem.[4]



Source: IGCP Government Debt Monthly Bulletin for January 2011

The Portuguese economy is expected to shrink by 1.4% in 2011, pushing the country further into recession. Domestic demand is expected to be particularly badly hit considering the austerity plans and lack of credit available in the economy. In any case, this economic forecast, of a 1.4% contraction, could well be overly optimistic.[5]

3 UniCredit Euro Compass Outlook 2011, 15 December 2010.

4 The rise in the cost of borrowing for Portugal has also increased the chances of a snowball effect on debt (i.e. the self-reinforcing effect of debt accumulation arising from a high interest rate and high debt levels). The fact that Portugal also has nearly 80% of its debt held abroad (by non-residents) makes it more vulnerable to market fears. Rolling over €18 billion in short term debt will cost €720m in interest (at the most recent short term bond auction, 16 February, interest rates on 12 month bills reached 4%).

5 This estimate also relies on a large increase in exports which has been a trend over recent years despite Portugal's other problems. This increase is, however, by no means guaranteed, particularly considering the likely increase in interest rates and the resulting strengthening of the euro.

At the same time, the deficit was estimated to be around 7.5% of GDP at the start of this year, around €11.8 billion,[6] down from 9.4% in 2009. However, this reduction has only been achieved by a one off accounting trick, meaning that in real terms the deficit has not come down that much.[7] Crucially, the increasing interest rates the country is forced to pay to refinance its debt (currently costing around 3% of GDP) could this year cancel out many of the savings that the Portuguese government makes through its austerity programme.

The ECB is already bailing out Portugal: It is the eurozone's worst kept secret that the ECB is effectively already bailing out Portugal by buying its bonds (which otherwise would be very hard to sell) and propping up the country's banks. The fact that borrowing costs are still rising for Portugal, despite ECB intervention, gives an indication of the country's vulnerable state.

Since May last year the ECB has bought €77.5 billion in government debt, with around €18 billion - €20 billion expected to be from Portugal.[8] No one can be sure of the exact amount due to the lack of transparency on the part of the ECB. But that Portugal has developed a dependency on the ECB is clear - when the ECB recently stopped buying bonds, Portuguese bond yields reached record highs.

In addition, the banking sector is also growing heavily reliant on the ECB, through Frankfurt's willingness to provide cheap credit. Portuguese banks have provided massive loans to the state and received government bonds as collateral. These bonds have then been used as collateral to gain cheap funding from the ECB.[9]

Essentially this boils down to the ECB – and therefore European taxpayers – bailing out Portugal via its banking sector.[10] It also means that Portuguese banks are using money they do not have, in order to lend to the Portuguese government – knowing that the ECB will continue to provide cheap credit. This kind of practice – using overvalued low quality collateral to gain massive loans – was one of the key drivers behind the sub-prime crisis.

The real amount of Portuguese debt being held by the ECB is therefore much higher than it seems at first glance, possibly amounting to €30 billion in total.[11] This means that firstly, the ECB has a much higher exposure to Portugal than is often thought (which should concern not least German taxpayers) and secondly, the Portuguese state is in more trouble than it admits. Combined with the movement of pension funds to reduce the deficit (see footnote 6), huge amounts

6 EIU country report on Portugal, December 2010. All currency conversions are done using the exchange rate of $1 = €0.7

7 Citi Global Economics view: The Debt of Nations by Buiter et al. Three pension plans of Portugal Telecom (PT) we taken over into the public social security system. These pension funds are for employees that used to be civil servants at the formerly state-owned firm. The agreement between PT and the government was signed in December and in addition to the assets of the pension funds, PT will transfer a total of €2.8 billion to the government. This amount (around 1.6% of GDP) will be counted in this year's general government revenues, while there is no change in the official debt figures.

8 Cited in Irish Times, "Portuguese borrowing costs rise", 16 February 2011 - Therefore the ECB may currently be holding around 14% of all Portuguese sovereign debt. : http://www.irishtimes.com/newspaper/breaking/2011/0216/breaking31.html

9 Banco de Portugal, Economic Bulletin: Autumn 2010, (pp34-40): This section of the report covers the entire nature of the lending between ECB, the Portuguese banking sector and Banco de Portugal. All of the facts and figures in the discussion above were drawn from here.http://www.bportugal.pt/en-US/EstudosEconomicos/Publicacoes/BoletimEconomico/BEAnteriores/Pages/default.aspx

10 Cited in BBC: Peston's Picks Blog, "The perilous condition of Portugal's banks", 30 November 2010: http://www.bbc.co.uk/blogs/thereporters/robertpeston/2010/11/the_perilous_condition_of_port.html

11 See Buiter et al. (p.38) for a full discussion of this issue.

of debt are swirling around the Portuguese economy without ever being dealt with.[12] The problem may be masked, but nothing is solved.

These actions further demonstrate how the ECB's impartiality and independence have fallen by the wayside during the eurozone crisis.

Lack of external credit is hampering internal lending: A bank lending survey conducted by Banco de Portugal, suggested that there was a significant tightening of credit policy during the last part of 2010, both in credit granted to enterprises and credit granted to households.[13] In other words, the vulnerable state of the Portuguese public finances is having a very negative impact on the economy as a whole.

2 HOW LARGE WOULD A PORTUGUESE BAIL-OUT NEED TO BE?

We estimate that a bail-out package for Portugal would need to be at least €70 billion. This amount would allow Portugal to cover all bond repayments as well as any government deficits up to the middle of 2014.[14]

Total cost of a Portuguese bail-out: €70bn[15]
Debt maturing this year = €16.8bn (Short and Long term from April onwards) Debt maturing in the next three years = €23.8bn (Long term only) Deficit for the next three years = €24.74bn (Apr 2011 – mid 2014) Banking sector aid = €5bn

Any bail-out would need to help Portugal cover its costs for at least three years, unlike the ones seen in Greece and Ireland which look increasingly like they will be insufficient.

Assuming that Portugal asks for a bail-out in April, the costs which would need to be covered include: the debt left to be refinanced this year, the deficit costs up to mid 2014 and the debt maturing up to the middle of 2014. The deficit is set to run at 7.5% of GDP this year and given the poor state of the Portuguese economy we do not expect the Portuguese government to be able to reduce this by more than 1.5% of GDP per year for the next few years.[16] For a breakdown of debt maturity see graphs in section 1. The bail-out should also provide some additional funding and liquidity for the banking sector, as in the cases of Greece and Ireland. We

12 Given the amount of sovereign debt held by Portuguese banks and the increasing likelihood of a bail-out or debt restructuring for the Portuguese state, the banking sector looks less healthy than originally thought. Particularly since the Tier 1 capital ratio is only around 8.5%.

13 Banco de Portugal, Bank Lending Survey, January 2011: http://www.bportugal.pt/en-US/EstudosEconomicos/Publicacoes/IBMC/Pages/InqueritoaosBancossobreoMercadodeCredito.aspx

14 Both UniCredit and Deutsche Bank have arrived at similar estimates. We are not including own government donations or bilateral loans which may make up part of any bail-out package.

15 Our estimate here focuses on costs for the next three years, and is based on Portugal asking for a bail-out in April 2011. Since the three year plan includes half of 2011 and half of 2014, we have had to half the deficit estimates of each year to get a rough idea of the funding needs. We did the same for the level of debt maturing in 2014.

16 EIU estimates a decrease of around 1% GDP per year; while the Portuguese government sees a 3% cut this year alone. Given the struggles to reach last year's deficit target we expect the actual decrease in the deficit to be somewhere in between but closer to the EIU estimate. Obviously the actual deficit levels will be affected by GDP growth and austerity plans, amongst other factors, however, our estimate is mainly to gives an indication of Portugal's potential funding needs.

expect that this could be around €5bn, which would help to encourage lending to households and small businesses throughout the Portuguese economy. Any such bail-out would likely include some contribution from the UK, although the exact amount depends on the specific structure of the bail-out.

3 WHAT WOULD THE UK'S LIABILITIES BE IN A PORTUGUESE BAIL-OUT?

David Cameron has already admitted that the UK might be liable for some portion of a Portuguese bail-out. We estimate that the UK's share in a €70bn bail-out of Portugal would range from €945 million to €4.26 billion, with the higher end of the estimate being more likely.

Looking at the Irish and Greek bail-outs, we can guess what structure the bail-out may take. The Irish bail-out saw the money being contributed by four sources: the EFSF, the EFSM and the IMF, with a third from each, in addition to a bilateral loan from the UK to Ireland. The Greek bail-out was slightly different with 70% coming from the EFSF and 30% from the IMF.

We assume that the UK would not contribute bilateral loans to Portugal due to political constraints:

Total UK contribution to a €70bn bail-out package	
Scenario 1: 'Irish Structure' for a Portuguese bail-out: (€23.3 billion from EFSF, EFSM and IMF each) **UK contribution: €4.2639 billion** EFSM - €3.2154 billion IMF - €1.0485 billion	**Scenario 2: 'Greek Structure' for a Portuguese bail-out:** (€49 billion from EFSF and €21 billion from IMF) **UK contribution: €945 million from IMF.**

The UK might have no choice but to get involved since all 27 member states, including Britain, are part of the EFSM, worth €60 billion (of which Ireland has already tapped €22.5 billion). This is because the EFSM involves the European Commission borrowing on the markets and then lending to member states, using the EU budget as collateral. In turn, this makes the UK liable through its gross contribution to the EU budget (its share was estimated to be 13.8% in 2010).[17] Extraordinarily, the activation of the EFSM is decided by Qualified Majority Voting, meaning that the UK does not have a veto over whether it should become partly liable in case of a Portuguese bail-out.

Scenario 1 therefore looks highly plausible. But because of the political complications in having a non-eurozone member contributing to a bail-out, scenario 2 is also a possibility should a non-eurozone member, for example the UK, be particularly opposed to being involved (but it could still be outvoted if it did not garner further support).

17 Only if a country defaults on some or all of its EFSM loans could the UK be asked to provide additional money to the EU budget: http://www.hm-treasury.gov.uk/d/european_union_finances_2010.pdf

BIS calculations put the exposure of UK banks to Portugal at around £16.1 billion, with UK banks having a lower exposure only to Greece. This puts the UK fourth in terms of banking exposure to Portugal with Spain, France and Germany above it (in the case of Greece it was third and in Ireland it was first). Clearly the exposure of the UK banking sector is limited and any losses incurred from a default or restructuring should cause little problem given the size and scope of the UK's banks.[18] Being outside the eurozone also means the contagion effects would be relatively limited in the UK. The biggest threat comes from Spain, which is heavily exposed to Portugal, and to which the UK banking sector is also significantly exposed. The UK's stake in a potential Portuguese bail-out therefore heavily depends on the risk of Portugal's woes spreading to Spain in the absence of a rescue operation – and whether a bail-out will actually solve anything.

As we demonstrate in the next section, a bail-out is unlikely to solve the substantial problems facing Portugal. In addition, as we argue below, the contagion risk to Spain is actually not huge – although there is a 'perfect storm' scenario in which case any dramatic movement in the Portuguese economy could lead to markets seriously questioning the viability of Spain.

Therefore, the case for the UK not taking part in a bail-out of Portugal is far stronger than in the case of Ireland, for example.

4 WHY A BAIL-OUT WON'T BE ENOUGH

A bail-out would in fact solve very little. It might help Portugal to finance its debt in the short-term and eventually return to the markets but the underlying problems which created this crisis in the eurozone still remain.

It's a competitiveness problem: Portugal has seen its cost competitiveness decrease by 5.5% since the euro was introduced, while Germany's has increased by 15.9%, a difference of 21.4%.[19] Since the inception of the euro, prices have risen significantly in Portugal, much faster than most eurozone members, especially the stronger ones. This combined with a large current account deficit and large debt levels in the public and private sector has produced the situation we see today.[20]

Economic Indicators	Portugal	Germany
	2011	2011
GDP growth (%)	-1.4	2.6
Debt to GDP (% of GDP)	82.4	75
Deficit (% of GDP)	7.5	1.7
Exports growth (%)	4.5	8.5
Imports growth (%)	1.9	8
Domestic Demand (%)	-1.3	2
10 yr bond interest rate (%)	7.43	3.23
Unemployment rate (%)	11	7.3

Source: EIU country reports on Germany and Portugal; IGCP debt figures.

18 The logic here is naturally that if no bail-out was forthcoming then Portugal would need to restructure its debt or incur a sovereign default. Contributions to a bail-out fund which is designed to prevent this outcome should be based on the countries relative gains from such prevention. In this case the UK's seem to be minimal.

19 According to harmonised competitiveness indicators based on GDP deflators collected by the ECB. Ones based on labour unit wage costs may be a better measure, but the data was unavailable: http://www.ecb.int/stats/exchange/hci/html/hci_gdp_S.en.html

20 Pimco, European Perspectives, "Plan B", January 2011.

Increase in interest rate will only worsen things: Inflation is expected to be around 1% in Portugal this year, although this may decrease due to low GDP growth, compared to around 3% in Germany. Due to German inflation fears, the ECB will remain under pressure to raise interest rates. Such a move would be detrimental to the Portuguese economy. With the government and the banking sector already struggling to finance or issue debt, an increase in the cost of borrowing would pour fuel on an already open fire. Credit and financing is already hard to come by in the Portuguese economy, with bank lending decreasing. These effects are likely to filter through and cause a decrease in domestic demand as well as a decrease in investment in the economy, both of which will cause GDP to contract further.

The government would also have little scope to use fiscal policy under the stringent bail-out austerity conditions. This further decreases the tools which the government has to return the economy to growth and long term stability.

As with Greece, Portugal's problem is not simply one of liquidity but mainly of competitiveness and solvency. Even removed of its debt burdens, the Portuguese economy would find it hard to compete in the eurozone.

5 IS IT BETTER TO GO STRAIGHT TO RESTRUCTURING?

In light of the arguments outlined on page 10, there is a strong case for skipping the bail-out and simply restructuring some of Portugal's debt burden. It seems to have become general eurozone practice to engage in a bail-out and then move onto restructuring later, if needs be (which most cases seem to). This practice has not been seen with previous supranational interventions such as those by the IMF around the world and the US in Latin America, in most cases any funding is accompanied by a reduction in debt levels. As long as the spectre of restructuring or default hangs over Portugal it will keep borrowing costs high and deter investors.

In the long run a restructuring may also prove cheaper despite a larger initial cost. A restructuring will become more costly over time, since over the coming years, Portuguese debt will only increase, meaning that a restructuring would incur even larger losses down the road.[21] Therefore, it makes economic sense to restructure now, before the country's debt reaches even higher levels. A bail-out will only serve to increase Portuguese debt even more.

To avoid fear spreading in the markets in the event of a Portuguese restructuring, it would probably have to be combined with some sort of cash injection to serve as back stop against contagion to other countries, most critically Spain. This would likely take the form of a more limited bail-out fund. Since some of the cost is being borne by investors, through the restructuring, government contributions can be a lot lower than the levels we estimated under a bail-out only scenario.

21 A higher debt level means that more debt needs to be restructured or reduced to bring the debt-to-GDP ratio to a sustainable level. This means larger write downs for all bondholders.

Pro Bail-out
• Appease bondholders' fears of losses and therefore halt contagion in its tracks (ideally) • Less likely to spook already jittery financial markets • The fallout of a bail-out is far more certain than that of a restructuring or default. • Brings down borrowing costs in the short term and possibly medium term, allowing the country to finance existing debt more easily • Gives the government room to enact austerity programmes and more economic policy flexibility
Pro Restructuring
• Imposes losses on bondholders rather than taxpayers • Significantly less moral hazard, sends a message to governments that excessive debt will not be tolerated and warns bondholders that they are not immune from losses • Puts Portugal on the long term path towards economic growth, debt reduction and debt sustainability • Stops the ongoing recycling and increase of debt within the eurozone • If properly planned and handled, contagion could be limited – the assumption that contagion would spread to Spain also looks far from certain • Both Ireland and Greece are already looking to renegotiate their bail-out terms, clearly it has not worked[21] • Will need to be done eventually and costs will only increase over time – as debt is yet to peak – so will uncertainty • Banking sector is equipped to deal with the losses imposed by a country the size of Portugal – capital reserves are higher and holdings of debt are less concentrated than a year ago[22] • Less reliant on political will of the government or population to enact harsh austerity measures • Similar long term solutions – such as fiscal union or permanent transfers of wealth – are not politically viable

A restructuring would put the Portuguese economy on a more sustainable path for the long term. It would also be fairer to taxpayers, since it will decrease government liabilities by imposing some of the costs on investors. Despite not having a veto, the UK should make its participation in a bail-out conditional on a restructuring.

The hope is that Portugal will use the cash and breathing space, freed up through a restructuring, to invest wisely in its own economy, including pushing through more economic reforms. However, the country will still be stuck with an over-valued currency, and the question is whether it can ever become competitive as long as it shares a currency with radically stronger economies such as Germany.

22 Obviously setting a high interest rate was a valid attempt to avoid moral hazard which many people feared would be widespread after the initial bail-outs. However, it looks to have backfired since both Ireland and Greece seem increasingly unable to repay at the set rate and maturity.

23 Cited in The Economist, "The euro area: Time for Plan B", 13 January 2011: http://www.economist.com/node/17902709?story_id=17902709

6 PORTUGAL GOES, SPAIN GOES?

The common perception is that if Portugal were to restructure, contagion would quickly spread to Spain. Although Spain's exposure to Portugal is significant we believe that the 'Portugal goes, Spain goes' assumption is still far from certain – but it could happen in a "perfect storm" scenario. Looking at the facts and figures it seems that the impact of a Portuguese restructuring on the Spanish economy has, arguably, been overstated.[24] The discussion should centre on what role a Portuguese restructuring could play in exacerbating a series of potentially negative events unfolding in and around the Spanish economy, such as a large number of people or businesses defaulting on their private debt, linked to real estate.

Large but manageable exposure: The Spanish banking sector exposure to Portugal is estimated to be around €62.2 billion.[25] Although this is higher than any other country's exposure, it is around half the UK's exposure to Ireland, in nominal terms (two countries which have a similar proximity and relationship to that of Spain and Portugal). Other exposures include €24 billion in foreign direct investment and about 9.1% of total exports.[26] According to figures from the Bank of Spain this is still less than 20% of the exposure of Spanish banks to the battered Spanish real estate and construction sectors.[27] Total exposure to Portugal is also less than 9% of GDP, with banking exposure around 6%.

More important factors in determining future of Spanish economy: Given the size of the Spanish economy this exposure seems relatively limited. Amongst the factors that will determine the future growth and stability of the Spanish economy, a Portuguese restructuring will rank fairly low on the list. Things such as the liquidity and solvency of the banking sector, ability to finance and reduce government deficits, realisation of losses from the housing bust and the level of household debt are all far more important factors for when and how the Spanish economy will recover from the current crisis. Spain is already working to tackle these issues.[28]

The cost of a €70bn bail-out package to Spain would also be relatively minimal. Based on the Irish bail-out structure, we estimate that Spain would be liable for around €5.6 billion through existing channels (EFSF, EFSM and IMF). Under the

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24 The spread of contagion will depend on many other factors, not limited to: the size and expectation surrounding the bail-out, as well as the terms of the bail-out. 25 BIS consolidated banking statistics, March 2011: http://www.bis.org/statistics/consstats.htm

26 EIU country report on Spain, December 2010. Both returns from FDI and level of exports may decrease, but this is very difficult to quantify and is unlikely to be a substantial cost for the economy.

27 Bank of Spain, Financial Stability Report, October 2010 (p.25) – It might be fair to question the validity of these numbers, given peripheral government's track records in disclose of statistics, however they are likely to be on the low side in any case, meaning exposure to Portugal would count for an even smaller percentage of Spanish banking exposure: http://www.bde.es/webbde/en/secciones/informes/boletines/Informe_de_Estab/anoactual/

28 The government established the FROB to provide up to €100 billion in funding to the banking sector when and if it is needed. The rules on capital holdings for banks are in the process of being reformed, while the heavily indebted local banks have been reorganized and aggregated. There has also been some effort on wage reform to improve the country's international competitiveness, such as removing the high costs of dismissal. Cited in The Wall Street Journal, " Spain ramps up job efforts", 17 March 2011: http://online.wsj.com/article/SB10001424052748703899704576204770009558938.html

Greek structure this rises to €6.3 billion. This could be increased through bilateral loans as seen in the case of the UK and Ireland.[29]

But there could be contagion under a 'perfect storm' scenario: However, it is also wrong to consider the Portugal – Spain relationship outside of other eurozone factors. There is a high probability of a Greek restructuring and an Irish bail-out renegotiation this year, as well as potential negative market reactions to weak banking stress tests and inconclusive EU summits. If a Portuguese restructuring – or even bail-out – were to coincide with any or all of these events, the spread of contagion to Spain could happen even in light of the facts and figures above. When dealing with jittery markets it is also important not to underestimate their self-fulfilling potential – since the markets believe contagion will spread from Portugal to Spain, it may become a reality.

There are also several potential developments inside the Spanish economy which could potentially trigger a run on Spain should they coincide with a Portuguese restructuring.

An increase in ECB interest rates, for example. Given the massive amount of private debt, much of which takes the form of variable rate mortgages, an increase in interest rates would decrease disposable income across the economy, thereby decreasing domestic demand and possibly harming employment.[30] There is also significant uncertainty surrounding the rest of the real estate sector, specifically prices and how much further they have to fall.[31] A massive decrease in real estate prices would likely push more people into negative equity and force more foreclosures. There would also be further losses for banks which are heavily exposed to the real estate sector.

It should also be said that by asking for a bail-out Portugal is also signifying that it is unable to fund itself. As such there is still a risk of increased market fears over the state of peripheral eurozone economies – and therefore possible contagion – even if Portugal opts for external help.

7 WHAT'S NEXT FOR PORTUGAL?

Following the fall of the government, Portugal's future has become increasingly uncertain. As noted in the introduction, a new government is unlikely to be formed until June; that is a significant period of time to be without leadership during an economic crisis. The fact that there are €4.5bn and €4.9bn worth of government bonds maturing in April and June respectively makes the situation even worse. It seems likely that Portugal will have enough cash to fund the debt

29 Spain's contributions to €70bn bail-out: 12% of the EFSF, 10% of EFSM and 2% to IMF budget. Therefore under these scenarios nominal value of contributions would respectively be: €2.796bn + €466m + €2.33bn = €5.6bn; or €5.88bn + €420m = €6.3bn

30 Cited in FT Alphaville, 'This is not a normal ECB tightening', 7 March 2011: http://ftalphaville.ft.com/blog/2011/03/07/506426/this-is-not-normal-ecb-tightening/

31 Cited in Assetz, 'Spain house price falls 'to continue', 10 March 2011: http://news.assetz.co.uk/articles/5610.html

maturing in April (otherwise it would have already asked for a bail-out) but will fall a long way short in June.[32]

Therefore, the main issue is whether a caretaker government would have the power and/or legitimacy to negotiate a bail-out package. As the experience in Ireland has shown, negotiating with a lame duck government can lead to significant problems, specifically having to deal with a renegotiation as soon as the new government comes to power. The interim government would also struggle to implement the stringent austerity conditions which accompany the EU/IMF bail-outs, in addition to the fact that anyone involved in committing the country to massive austerity in the near future would face a large political backlash.

However, there is also a cost involved in waiting until June to ask for a bail-out. Not only will borrowing costs continue to rise during that period but the process of tackling the massive economic problems in Portugal will be put on hold. Given a settling in period for the new government, a significant amount of time could pass until the process gets underway again. The actual cost of this is unclear but given the fact that the deficit predictions as well as the growth predictions are based on the previous government's ambitious reform programme, we could see lower growth combined with higher spending and lower tax revenue than had been expected.

There are other ways in which Portugal could gain some interim funding. The ECB is the source of both. Firstly, Portugal could issue more debt and sell it to Portuguese banks that would use it as collateral to gain cheap loans from the ECB. As we noted above, this is already happening but is far from a desirable state of affairs. Not only does it increase debt, it also increases Portuguese banks' exposure to the state, increasing the risk of contagion. Secondly, the ECB could buy up more Portuguese debt (under the so-called Securities Market Programme). However, the ECB has become increasingly hesitant about buying bonds, particularly due to the levels which Portugal would require. ECB President Jean-Claude Trichet might also be unwilling to help out eurozone leaders after they refused his calls to allow the permanent bail-out fund to purchase government bonds. For these reasons, both these funding options are unlikely to be undertaken, but may not help to stave off a Portuguese bail-out even if they were.

Therefore, it looks as if the interim Portuguese government may be forced to negotiate a bail-out, unless a plan is quickly drawn up on how to fund Portugal until June.

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32 The claim to have enough cash has been mostly coming from the Portuguese government and so may be misleading but markets seem to have accepted it. It is possible that the repayment could be covered by taking on more short term debt or increasing the deficit, neither of which would help.

ANNEX: ALTERNATIVE BAIL-OUT SCENARIOS

Given the uncertainty over any EU negotiations as well as the deepening political and economic crisis in Portugal, there are numerous levels at which the Portuguese bail-out could be set. We have specified the amounts which we believe are most likely in our paper; however, since it is unclear we have also laid out the other scenarios below.

Total cost of a Portuguese bail-out: €60bn
Debt maturing this year = €12.3bn (Short and Long term from June onwards)
Debt maturing in 2012 and 2013 = €17.25bn (Long term only)
Deficit for the next three years = €28.3bn (2011 - 2013)
(This leaves €2.15bn leftover, which could be used to aid the banking sector, or simply to allow some room for manoeuvre within the bail-out)

Under this package Portugal would be funded until the start of 2014. We use slightly different assumptions under the larger packages (such as start and end points) to demonstrate exactly what each bail-out package could cover. This is likely the lowest viable level for a bail-out package since it only just manages to cover Portugal up to the end of 2013. Any lower and the money would not be sufficient to cover Portugal's costs for a reasonable amount of time.

Total amount of a Portuguese bail-out: €80bn
Debt maturing this year = €16.8bn (Short and Long term from April onwards)
Debt maturing up to the end of 2014= €30.4bn (Long term only)
Deficit for the next three years = €27.1bn (Apr 2011 – end 2014)
Banking Sector Aid = €5.7bn

An €80bn bail-out package could take Portugal off the market until the end of 2014. This includes covering the debt as well as the deficit from now until the end of 2014. There would also be scope to provide the banking sector with €5.7bn to aid recapitalisation or to encourage lending to households and SMEs.

Total amount of a Portuguese bail-out: €90bn
Debt maturing this year = €16.8bn (Short and Long term from April onwards)
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Deficit for the next three years = €27.1bn (Apr 2011 – end 2014)
Banking Sector Aid = €15.7bn

A €90bn bail-out would take much the same form as the smaller packages but would provide a larger amount of additional funding for the banking sector. The extra funding could also be put towards covering or reducing some of the short term debt which may still be required for unforeseen funding costs over the three

years. In all cases the make up of the bail-outs could easily be amended depending on exactly when the bail-out is taken and the situation in the Portuguese economy. Our breakdowns are guides to the most important costs which will need to be covered.

Obviously, the amount that the UK would be liable for increases with the level of the bail-outs, however, there is still a very large range given the various structures which the bail-out could take.

Total UK contribution to a €60bn bail-out package	
Scenario 1: 'Irish Structure' for a Portuguese bail-out: (€20 billion from EFSF, EFSM and IMF each) **UK contribution: €3.660 billion** EFSM - €2.760 billion IMF - €900 million	**Scenario 2: 'Greek Structure' for a Portuguese bail-out:** (€42 billion from EFSF and €18 billion from IMF) **UK contribution: €810 million from IMF.**

Total UK contribution to a €80bn bail-out package	
Scenario 1: 'Irish Structure' for a Portuguese bail-out: (€26.6 billion from EFSF, EFSM and IMF each) **UK contribution: €4.87 billion** EFSM - €3.67 billion IMF - €1.2 billion	**Scenario 2: 'Greek Structure' for a Portuguese bail-out:** (€56 billion from EFSF and €24 billion from IMF) **UK contribution: €1.08 billion from IMF.**

Total UK contribution to a €90bn bail-out package	
Scenario 1: 'Irish Structure' for a Portuguese bail-out: (€30 billion from EFSF, EFSM and IMF each) **UK contribution: €5.49 billion** EFSM - €4.14 billion IMF - €1.35 billion	**Scenario 2: 'Greek Structure' for a Portuguese bail-out:** (€63 billion from EFSF and €27 billion from IMF) **UK contribution: €1.215 billion from IMF.**

It is important to note that any bail-out would not impose direct costs onto the UK, other than the cash contributions which the UK makes to the IMF. The EFSM involves the European Commission issuing debt from the mechanism, using the EU budget as collateral. This money then makes up the funding provided to any country asking for a bail-out. Since the UK contributes to the EU budget, it guarantees a certain portion of the loans given to any bail-out recipient under the EFSM (the UK's share is around 13.8%). However, this is still significant for UK taxpayers, as it effectively requires them to underwrite the debt of peripheral eurozone economies. The liabilities also significantly increase the level of UK exposure to these economies. In any case, if a firm took on large liabilities they would need to be declared in its accounting procedures and would be taken account of by anyone who assessed the financial state of the company. The same should definitely be true of governments.