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# The Road to Portugal's Bailout Exit


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Portugal has made substantial progress in recent years and now looks set to make a "clean exit" from its bailout on May 17. With a recovery firmly underway and improvements in the country's market access, we think a positive near-term stance on Portuguese government bonds is still warranted.


Portugal's economic recovery has gained traction over the past year. Since exiting a two-and-a-half-year recession in the second quarter of 2013, the economy has grown for three consecutive quarters.

In the fourth quarter of last year, the economy expanded by 0.6% quarter over quarter, led by a recovery in fixed investment. With the turnaround in economic conditions, the unemployment rate has sharply declined from a peak of 17.6% in February 2013 to 15.3% in January 2014—the largest improvement in the euro area over this period.

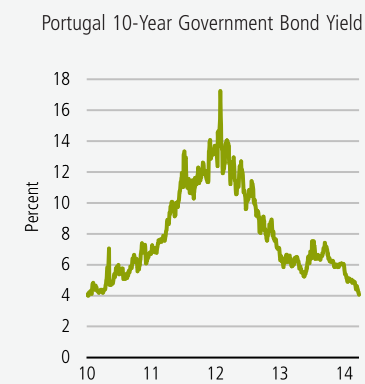
The economic recovery has generated renewed optimism among policymakers about the country's ability to move forward from the crisis. With Portugal's three-year, €78 billion bailout from the European Union (EU) and International Monetary Fund (IMF) now close to its termination date on May 17, the domestic debate has turned to preparations for a post-bailout environment. We believe that a successful exit from the bailout would represent an important symbolic transition, and mark a return towards some type of normality.

### Preparations for Bailout Exit

In the run-up to May, Portugal's primary objective is to reestablish market access and return to normal bond auctions. To do this, the government has been busy in recent months consolidating investor interest, easing a return to markets in several steps and reducing near-term financing needs. These actions have contributed to a rally in Portuguese bond yields **(Display 1)**.

As the bailout exit approaches, the government must also make an important decision in the next month or so on whether it intends to leave the loan facility with or without a precautionary credit line from the EU. In light of the recent favorable developments in market conditions and in the country's funding position, we now believe that Portugal will be able to make a "clean exit" from its bailout on May 17.

Display 1
**Rally in Portuguese Yields**




As of March 27, 2014
Source: *Financial Times*

### Return to Markets

To prepare its return to capital markets, Portugal has generated a flurry of recent market activity. Last December, the government announced its return to international bond markets by conducting a major debt exchange to reduce near-term maturities—buying back €6.6 billion worth of 2014 and 2015 bonds in exchange for issuing a similar amount of 2017 and 2018 bonds. This was followed in January and February by a return to syndicated issuance, with two bond retaps completed that raised about €3 billion each. Both issuances were overbooked. And, more recently, the country has completed two smaller bond buybacks.

While last week's buyback was a disappointment, these activities have in total notably reduced the country's financing requirements for the next two years **(Display 2)**.

In the last three months alone, the country has knocked about €14.7 billion from its near-term financial needs. At present, the remaining financing gap for 2014 and 2015 amounts to about €15.4 billion in total, to be met via additional issuance, debt swap exercises and retail debt channels. As the next step, the government is currently exploring investor interest in a new USD-denominated bond.

These actions come as no surprise, and are intended to improve Portugal's financing position as the country exits its bailout. The objective has been to pre-fund 2014 and 2015 borrowing requirements at a time when market conditions are favorable. So we expect more of these market activities to follow, and that resulting improvements in the country's market access and funding position will continue to place downward pressure on Portuguese bond spreads.

## A Clean Exit?

Importantly, there is also a political motive to these actions, revolving around whether Portugal leaves the bailout with or without a precautionary credit line from the EU. Late last year, most observers considered a precautionary credit line to be the best way forward, as this would provide a readily accessible buffer (of up to €17 billion, or 10% of GDP, in precautionary funds) in case market conditions turned south—especially relevant given the substantial financing needs post the bailout in 2014 and 2015.

But a precautionary credit line would come with additional policy conditionality—a hotly debated issue in Portugal, which is keen to regain its national sovereignty. We wrote recently on the important part that public opposition to austerity plays in the present political environment (see "Portugal: The Politics of Austerity," *European Perspectives*, October 11, 2013). With better market conditions, the government is attempting to build up its cash buffer (which currently stands at around €15 billion) in part to limit the need for precautionary funds. The hope is that this will allow Portugal to follow Ireland's example and make a "clean exit" (without a precautionary line) from its bailout.

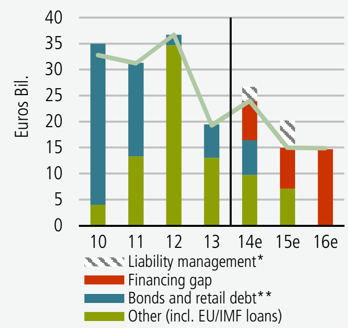
There is currently no decision on whether Portugal will make a clean exit or not. Prudently, the government has decided to delay this decision to late April or early May so that it can have the maximum information available. In the meantime, it is in the process of consultation with key national stakeholders and with the EU. We do not think Portugal is as prepared as Ireland was to make a clean exit because its cash buffer is smaller, yield levels are higher and macroeconomic fundamentals are less advantageous. However, the recent substantive improvements in Portugal's circumstances do mean that a successful clean exit scenario is notably more likely than we thought a few months ago. We have, therefore, revised our base case to expect that Portugal will make a clean exit from its bailout on May 17, driven by political considerations but supported by improvements in funding conditions and domestic fundamentals.

Importantly, even a clean exit from the bailout would not completely exempt Portugal from EU and IMF surveillance. It would still be subject to two biannual reviews (instead of the four quarterly "troika" visits) as part of a new post-bailout monitoring procedure that would remain in place until the country had paid back 75% of the bailout loans—a period that could last decades. And, while these reviews would be very different from the current troika visits, which demand specific policy changes, they would continue to make recommendations on economic governance. This fact has been well acknowledged by the government, with the president recently describing it as an "illusion" to think that strict budget discipline would end after the conclusion of the bailout.

Display 2

**Improvements in Funding Needs**

Financing Requirements by Source of Financing




As of March 28, 2014

*The shaded area represents the reduction in funding needs for 2014/2015 due to the debt exchange and debt buybacks.

**2014 bar includes the €6.25 billion already issued this year.

Source: European Commission, IMF, Portuguese Treasury and Debt Management Agency and AllianceBernstein

## Reason for Optimism

In our view, there is reason for some optimism on Portugal as the turnaround in the economy continues and the country prepares its important transition from the bailout. While domestic conditions will remain very challenging for many years and there are still multiple economic and political issues to confront, the recent developments mark critical steps forward and May's bailout exit will symbolize a milestone on a long-term recovery path.

In the next few months, we expect that Portugal will join Ireland as the second country to exit its troika bailout. In the process, this would put forward an additional point of hope that the worst of the crisis in recent years might be past. ■