Portugal’s Coalition Splinters on Austerity Fatigue: Euro Credit
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By Anabela Reis and Joao Lima

July 3 (Bloomberg) -- Portuguese borrowing costs topped 8 percent for the first time this year after two ministers quit, signaling the government will struggle to implement further budget cuts as its bailout program enters its final 12 months.

Secretary of State for Treasury Maria Luis Albuquerque replaced Vitor Gaspar at the Ministry of Finance. That prompted Paulo Portas, who leads the smaller CDS party in the coalition government, to quit, saying the new minister would offer “mere continuity” of the country’s deficit-cutting plans.

“It sounds the alarm bell of austerity fatigue,” said David Schnautz, a strategist at Commerzbank AG in New York.
“This domestic noise is definitely negative.”

Portugal’s 10-year bond yield jumped to 8 percent earlier today, the highest level since Nov. 27, and was hovering at 7.65 percent as of 11:10 a.m. London time. The nation pays an average 3.2 percent for loans it received as part of the aid package.

Prime Minister Pedro Passos Coelho is battling rising unemployment and a deepening recession as he cuts spending and increases taxes to meet terms of a 78 billion-euro ($101 billion) rescue plan monitored by the European Union, the International Monetary Fund and the European Central Bank, known as the Troika. Coelho announced measures on May 3 intended to generate savings of about 4.8 billion euros through 2015 that include reducing the number of state workers.

Coelho Speech

“I will try to clarify and guarantee with the CDS party all the conditions for the stability of the government and to proceed with the strategy of overcoming the nation’s crisis,”
Coelho said in a speech last night, adding that he has no plans to resign.

The difference in yield that investors demand to hold 10- year Portuguese bonds instead of German bunds is about 600 basis points, exceeding this year’s average of 461. The gap is down from a euro-era record of 16 percentage points in January 2012.

“The issue at stake here is whether the present government follows policies of fiscal responsibility or not,” said Ciaran O’Hagan, head of European rates strategy at Societe Generale SA in Paris. “The public seems to imagine a better deal with the Troika can be struck, as if Greece and Cyprus are not sufficient warning.”

The eighth review of Portugal’s aid program is due to start on July 15, the Finance Ministry said on June 19.

Government Tensions

Coelho said he didn’t accept Portas’s resignation and hasn’t asked President Anibal Cavaco Silva to dismiss his partner, citing the foreign affairs minister’s role as leader of a coalition party.

“Portas’s resignation is likely to prove final, and he seems to have the solid backing of both his party and its supporters,” Mujtaba Rahman, a London-based analyst at Eurasia Group, said in a note today.

Social Security Minister Pedro Mota Soares and Agriculture Minister Assuncao Cristas will hand in their resignations to Coelho today, broadcaster TVI reported on its website last night, without saying how it obtained the information. Both ministers are from Portas’s CDS party.

"The grand bargain in the euro zone is that the strong, notably Germany and the ECB, support the weak and that the weak accept the conditions attached to such support," Christian Schulz, an economist at Berenberg Bank in London, wrote in a note following the Portuguese resignations. "If one country were to lose the political will to stay the course, tensions in the euro zone could rise again."

Market Return

Portugal has planned to return to the bond markets with the country's aid package scheduled to end in June 2014. The nation sold 10-year bonds on May 7 for the first time in more than two years as a global decline in interest rates spurred demand for higher-yielding assets. Portugal had stopped selling bonds until this year after requesting the bailout in April 2011.

The country has started the pre-financing for 2014 and already has all of the funds it needs for this year, Portuguese Finance Minister Vitor Gaspar said on May 7.

"Ambiguity over the medium term financing plans is still something of a challenge," Eurasia's Rahman said.

A deeper recession and higher unemployment levels are "exacerbating social and political tensions and, in turn, testing the government's resolve to continue with adjustment policies and reforms," the IMF said June 13 in a staff report about the seventh review of the aid program.

Big Challenges

"The risks and challenges of the near future are enormous," Gaspar wrote in his resignation letter dated July 1.
"They demand government cohesion."

The EU may consider extending the deadline for Portugal to meet its deficit targets if economic conditions worsen, Jeroen Dijsselbloem, head of the group of euro-area finance ministers, said on May 27. Dijsselbloem said the government hasn't yet requested another change of timetables and targets.

On March 15, the government announced less ambitious targets for narrowing the budget deficit as it forecast the economy will shrink twice as much as previously estimated this year. It targets a deficit of 5.5 percent of gross domestic product in 2013, 4 percent in 2014 and below the EU's 3 percent limit in 2015, when it aims for a 2.5 percent gap. Portugal forecasts debt will peak at 123.7 percent of GDP in 2014.

Gaspar's resignation shows the risk of reforms faltering, Organization for Economic Cooperation and Development Chief Economist Pier Carlo Padoan said yesterday at the Lisbon Council in Brussels. "Fatigue may suddenly erupt and the temptation to go backward may be very, very strong," he said.

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