Is Portugal the Next Domino to Fall?

Nicolas Véron is confident that Portugal can solve its problems without resorting to a debt write-down that would rattle European markets.

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Steve Weisman: Is Portugal the next country to be hit by contagion in Europe? This is Steve Weisman at the Peterson Institute for International Economics, with Nicolas Véron, visiting Fellow and Senior Fellow at Bruegel in Europe. Nicolas, how concerned should we be that Portugal's problems might force it to write down its debt as Greece has, and also undergo austerity that might be unacceptable to the Portuguese people?

Nicolas Véron: We certainly should be concerned about the austerity and growth prospects of Portugal, which do not look splendid right now, but I don't think we should be concerned in terms of financial contagion. And Portugal is a very different case from Greece.

I think actually it will be the intent and driving principle of eurozone policy makers to show to the marketplace and to external stakeholders that Portugal is not Greece, and Greece was indeed a unique case in terms of debt restructuring. So my expectation is that Portugal will need a second program, and this is in line broadly speaking with large swatches of the marketplace. Portugal will need a second program.

Steve Weisman: A second program of what?

Nicolas Véron: New money or different conditions for the borrowing it has taken in the spring last year from official sources, EFSF [European Financial Stability Facility] and IMF [International Monetary Fund]. Currently, the Portuguese government says it can return to borrowing from the marketplace in September 2013, but I think more and more people believe this will be difficult.

Basically, for its future funding needs to be met, it will need more official assistance and is likely to ask for it in the next few months, probably at some point between the summer and the early fall. But what is crucial is that the conditions for this second program are very likely, in my view, to be completely different from the ones that were asked from Greece. And this is for two reasons. Basically I expect there will be no call for private sector involvement, for private sector creditors to take a haircut in the restructuring as it did in Greece.

And there are two main reasons for that. First, the eurozone policy makers realize that the economic and financial disturbance created by the private sector involvements, the debt restructure in Greece, has been much bigger than what they had initially expected, and they want to avoid further contagions. They realize they may have made a mistake, and they don't want to go further with private sector debt restructuring for the time being, at least. Of course, no one can [predict] the future on a more long-term basis, but right now, there is no willingness for it in policy circles.

The second reason is that, actually, Portugal is doing everything it has to do to give them a good excuse, if you want to look at it this way, for this differential treatment. And the fact here is that Portugal is reforming, is engaging in structural adjustment and in fiscal adjustment in a way that is much more credible, much more hands-on, and much more effective than was the case with the Greek government.

Portugal has privatized a lot of assets, perhaps ten times as much as Greece as the current counting goes. Portugal is reforming its labor market; it's reforming its competition law; it's reforming to a certain extent its economic structure, the professions; all that in a way that is much more proactive than was the case in Greece.

And there has been also a lot more consensus among national stakeholders, employers, labor unions, and the government, especially in terms of labor market reform with the landmark agreement between these three groups in mid-January. The fiscal adjustment is also very aggressive. Portugal has cut a lot of income for public servants, and also on the structural side has incentivized basically private sector firms to cut income for private sector employees; so internal devaluation in way that Greece has been much less quick to do.

Basically eurozone leaders can say, "Look, Portugal is a good pupil. Its situation is difficult, but it's doing everything it has to do, and therefore we're not insisting on the sort of harsh, almost punitive measures that were adopted for Greece."

Steve Weisman: What voices are saying that Portugal can't make it unless it has a private sector involvement, a haircut for creditors? Lawyers who went to Greece?

Nicolas Véron: There are a couple of lawyers that made a lot of money in Greece, that's for sure. But no, I think people who haven't looked at Portugal say, "Well, Portugal is the weak link. There is always a weak link in the chain. It used to be Greece. Now that Greece is stabilized, it's Portugal." And it is true that Portugal certainly is a country that has a most difficult situation among eurozone countries with the possible exception of Cyprus, but that's an outlier; certainty among the countries under program, compared to Ireland which is going much better, and compared to Spain and Italy.

So, Portugal is a normal next step to look at after the intervention in Greece, but many people have talked a bit loosely about Portugal being the next domino to fall, without actually looking at what was happening in that country. And I think the closer you look, the more you realize that actually, there's a good case, which will probably be implemented, for the eurozone leaders to actually treat it completely differently.

Steve Weisman: Thank you, Nicolas.

Nicolas Véron: Thanks, Steve.