Global Economy

Portugal: orthodoxy, certainty and reward

Expansión (Spain)

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A couple of years ago, the risk premium paid by the Portuguese 10-year government bond against its German counterpart was hovering between 350 and 400 basis points (bp). Meanwhile, the Spanish 10-year bond was paying between 100 and 125 bp. Today, the distances have been considerably reduced, and while Spain continues to pay an extra yield similar to that of a few years ago, the Portuguese risk premium is now barely 10 or 15 bp above the Spanish. What is the explanation for such a major change in investors' perception?

The answer must be found in the strict adherence to fiscal discipline that has been shown by the Portuguese government. In particular, although part of the drop in the imbalance of public finances is due to cyclical factors, another part is the result of permanent improvements. For example, while it is certain that the upturn in tax revenues and the decline in expenses is partly due to the reduction in the unemployment rate and the increase in the disposable income of businesses and households, the structural deficit (the deficit that should remain after those cyclical factors disappear) is around 0.5% of GDP. According to the estimates of the European Commission (EC), this represents a reduction of 2 pp of GDP compared with the level seen in 2015. By comparison, in the case of Spain, the EC estimates that the equivalent figure is almost 3% of GDP in 2019 and that there has been no improvement since 2016.

Another factor that may explain this relative improvement in the perception of the Portuguese economy is that the uncertainty about economic policy has been considerably reduced. This is due not only to the good management of the public finances, but also to the messages about the permanence of many of the reforms introduced in the last few years (particularly the reform of the labour market), even after changes of government.

There is no doubt that the adjustment to an orthodox fiscal policy has had a cost in terms of activity in the short term. However, the recent reduction in financing costs, thanks to the better outlook regarding the solvency of the public finances and the maintenance of what are perceived to be reforms that have increased growth capacity, may be the prelude to greater strength for the Portuguese economy. In particular, the country could be one of the biggest beneficiaries of a policy of low interest rates for a longer period of time. This would be due to the greater confidence that it would bring, as well as an additional reduction in the cost of financing for businesses and households, which in other countries has already bottomed out.

In any event, it is also certain that part of this improvement in the perception of the Portuguese economy may be temporary and more the result of the current high liquidity in the markets, as well as the search for yield among investors. For example, the savings rate of households remains at dangerously low levels. This has pushed the current account into deficit, in an environment where net indebtedness with the rest of the world remains very high. Moreover, the growth of the external sector is being threatened by the slowdown of the European economy and by the loss of competitiveness of the tourism sector against alternative destinations. In addition, the duality of the labour market persists, since although the measures taken may have strengthened job creation, they have not succeeded in reducing the share of temporary contracts. Finally, the nonperforming loan rate in the financial sector remains relatively high, even in an environment where the economic situation has improved considerably.

In summary, the market appears to be rewarding the Portuguese economy for an orthodox fiscal policy and for the reduction in uncertainty about economic policy. In any event, part of the improvement may be temporary, and the Portuguese government would do well to take advantage of this favourable environment to implement additional measures that continue to reduce the vulnerability of the economy.

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