Default looms as Portugal's bonds downgraded to "junk" status

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The downgrading of Portuguese bonds to junk status has provoked bitter recriminations from European Union leaders, who fear for the stability of the entire continent.

On Wednesday, Moody's credit rating agency downgraded Portugal's bonds to "junk" status. Moody's dropped Portugal four points from Baa1 to Ba2. The other two major agencies, Standard & Poor's and Fitch Ratings, both rate Portugal BBB-minus, one point above junk status and are considering revising down the country's credit-worthiness.

"The market is working on the assumption that by the end of the month, Fitch will also have downgraded Portugal, at which point they will drop out of most of the key sovereign indexes", explained Legal & General Investment Management analyst Ben Bennett.

Portugal is the second nation after Greece in the euro-zone to receive junk bond status. It increases the likelihood of the country having to restructure its sovereign debt or declare a default. In turn this is fuelling speculation that the efforts of the European Union (EU) to avoid contagion spreading from Greece to Portugal and Ireland will fail. Worse still, Spain and Italy are now widely considered to be under threat.

Moody's said it had downgraded Portugal because it is unlikely to meet its deficit reduction and debt stabilisation targets, agreed as part of the €78 billion ($113 billion) bailout package in April with the "troika"—the European Commission (EC), European Central Bank (ECB) and International Monetary Fund (IMF).

"Portugal will not achieve the deficit reduction target—to 3 percent by 2013 from 9.1 percent last year as projected in the EU-IMF programme—due to the formidable challenges the country is facing in reducing spending, increasing tax compliance, achieving economic growth and supporting the banking system", said Moody's.

A second round of official financing and further austerity measures will be needed, the credit agency warned. British Private Equity & Venture Capital Association chief economist Colin Ellis said the financial markets fear that Portugal is likely to follow Greece, saying "For months people have been saying that Greece will eventually have to restructure in some shape or form and the risk now is that the market is saying it might be the same for Portugal."

Moody's downgrade caused a sharp drop in the Lisbon stock exchange and the interest the government has to pay on its borrowing soared to record highs. The yield on three-year treasury bonds reached 19.14 percent on Wednesday—more than five percentage points in one day. Yields on two-year bonds rose to 17.19 percent and on 10-year bonds to 14.15 percent—unsustainable levels which make it impossible for the government to raise money from private investors, a condition of April's bailout.

The yields on two-year Irish bonds rose more than two percentage points to 15.30 percent and Greek two-year bonds increased to an unbelievable 27.53 percent.

Spain's 10-year bonds rose to 5.62 percent, back above the 5.5 percent level regarded by analysts as a sign that a bailout will be necessary. Yields on Italy's 10-year bonds exceeded 5 percent for the first time since 2008. Italy has more than €860 billion of notes maturing in the next five years, meaning annual interest costs will jump by more than $14 billion, according to Gary Jenkins at Evolution Securities Ltd. "If contagion spreads to the point where Spain is unable to fund itself in the market and there is concern over private participation in any bailouts, it is difficult to see how highly indebted Italy could escape unhurt", he wrote.

In comparison, Germany only had to pay 1.75 percent on two-year bonds sold this week.

Moody's made clear that the banks and financial speculators will not accept any of the costs arising from the crisis they created. A major reason behind its sharp

downgrade of Portugal was the breakdown of talks over the EU's handling of the Greek sovereign debt crisis and the attempts to get private investors to take part in the rescue effort, Moody's said. Standard & Poor's has also warned that it would treat the current French plan for a partial rollover of Greek sovereign debt as a "distressed debt exchange" and declare it to be a selective default.

Moody's provoked a bitter response from the EU, which now all but openly speaks of the ratings agencies as de facto agents of a foreign power—the US.

Threatening a clampdown on the activities of credit agencies, the EU is considering legislation to suspend ratings on countries receiving aid from the EU and IMF. Officials are looking to encourage the emergence of a Europe-based rival to Moody's, Standard & Poor's and Fitch Ratings, which are all based in New York.

"This unfortunate episode once again underlines the issue of the behaviour of the credit rating agencies and their so-called clairvoyance," declared a spokesperson for EU economics commissioner Olli Rehn.

"It is quite strange that the market is dominated by only three players and not a single agency is coming from Europe. It shows there may be some bias in the market when it comes to evaluation of issues in Europe, that Europeans know better than others," said José Manuel Barroso European Commission president and a former PSD prime minister of Portugal.

German Finance Minister Wolfgang Schauble claimed there was "no factual justification" for the downgrade and that "We must break the oligopoly of the rating agencies."

For the new Portuguese Prime Minister, Pedro Passos Coelho of the right-wing Social Democratic Party (PSD)-Democratic and Social Centre-People's Party (CDS-PP) coalition government, Moody's downgrade of Portugal to junk status was "a punch in the stomach".

Only a couple of months previously, Passos Coelho had pledged to "go further" than the troika demanded, doing "whatever it takes" to "guarantee that targets are fulfilled" in order to "restore international confidence".

Just last week he had won support in Congress for new austerity measures, including a 50 percent tax on workers' traditional Christmas bonus and the postponement of the Lisbon-Madrid high-speed railway.

Finance Minister Vítor Gaspar criticised Moody's for failing to understand the austerity measures, which were "proof of the government's determination", or for recognising that a "broad political consensus" supported the terms of the country's €78 billion bail-out. The downgrade was "immoral and insulting", said Fernando Faria de Oliveira, chief executive of the state-owned bank Caixa Geral de Depósitos.

The conditions attached to the bailout, signed by the caretaker government headed by the former Socialist Party Prime Minister José Sócrates and agreed to by the PSD and CDS-PP, were already draconian—demanding that the Portuguese ruling elite wage social and economic warfare against working people in order to funnel money into the pockets of the global economic oligarchy.

Whichever government came to power after the election was pledged to slash the budget deficit to 5.9 percent of GDP in 2011 from 9.2 percent at the end of last year, 4.5 percent in 2012 and 3.0 percent in 2013. There had to be further cuts to public services including education and health, a far-reaching reorganisation of central and local government, the justice system and the "regulated" professions, and cuts in state support to public bodies and subsidies to the private sector. State-owned enterprises in the telecommunications, postal services, energy and transport sectors had to be rationalised, liberalised and privatised.

The incoming government was required to cut further the number of public-sector workers, continue to freeze wages, pensions and the €485 ($690) monthly minimum wage and slash benefits. Labour reforms were a top priority, including changes to work patterns like making dismissals easier, cutting overtime rates and redundancy payments and dismantling national wage bargaining structures.

One of first acts of the new Minister of Economy and Labour, Álvaro Santos Pereira, after the June 5 election had been to call in the social partners—big business and trade union leaders—for discussions. "I have the greatest expectations and I'm sure we'll get a very fruitful dialogue", he announced, shortly before meeting a delegation from the Communist Party-aligned Portuguese General Workers' Confederation (CGTP) which, like its counterparts across Europe, is tasked with policing the imposition of austerity measures on the working class.