Written by Bruce Walker on May 5, 2011

Will Portuguese Bailout Unravel the EU?

The tiny nation on the Iberian Peninsula, forced to seek a bailout after its government collapsed last month, has only a caretaker government now. The announcement of the bailout came in the middle of Portugal's general election campaign. As savvy analysts of the times understand, governments never reveal the full extent of bad news before elections; therefore, what Portuguese officials have disclosed so far is doubtless the rosiest picture of a national government in free fall.

Some terms of the bailout will have severe ramifications for those who have long relied upon the welfare state for sustenance. Unemployment benefits, for example, will be reduced from the current period of three years to one and a half years. State pensions greater than €1,500 a month will be reduced. The deal negotiated, however, leaves much untouched: There will be no reduction in public employee pay, the minimum wage will stay the same, the retirement age has not been increased, and public employees will continue to receive Christmas and vacation bonuses. Officials hope that the higher taxes and spending cuts included in the bailout will collectively produce a contraction of the national economy by 2 percent over the next two years.

The plan includes some privatization of firms such as Air Portugal and the national mail company. Shares of other public businesses, such as EDP (the energy company) and REN (the national electrical distribution company) will be sold. Privatization revenues are estimated at €5.3 billion through 2013.

Though Portugal's financial woes are not identical to those of Greece and Ireland, or the other European nations, all these EU member states suffer from government overspending, playing fast and loose with public debt, overly rosy economic analyses, and increasingly untenable interest rates on government bonds. Portugal has just issued €1.12 billion in three-month treasury bills at 4.652 percent, alarmingly higher than the rate of 4.046 percent interest last month.

Though the interest rate on the EU loans will not be announced until the the Finance Ministers of the euro zone meet later this month, Portugal must accept the plan — by June 15. The Social Democrats, currently the opposition party, have been involved in the negotiations, and the EU requires their assent before the bailout can proceed. Party leader Pedro Passos Coelho has indicated that they will accede to the plan. A member of the governing Socialist Party has described the two previous bailouts as a "huge failure."

The government has been involved in negotiating a bailout for the last two months, and the terms when formally announced will be watched closely by two other PIGS nations — Ireland and Greece. Portugal's caretaker Prime Minister Jóse Sócrates — who has resigned from his post but will not leave office until early June — has stated of his country's difficulties, "The international institutions have acknowledged that Portugal's circumstances are very different from those of other countries and very different from the picture that some people here would like to paint."

Portugal was given an extra year to meet budget deficit targets after it was revealed that the deficit was much larger than expected for the current year. The deficit in 2010 was 9.1 percent. The goal now is to reduce it on a gradually decreasing scale from 5.9 percent this year to 4.5 percent in 2012. After the announcement of an agreement on budget deficit targets, the rate on government 10-year bonds dropped (for the first time in quite a while) from 10.32 percent to 9.95 percent. The present rate, however, is still considered high for bonds backed by a national government, and the 10-year bond news, though welcome for the government, also underlines just how low a view investors have of Portugal's ability to repay its loans.

Barclays Capital received the news with guarded optimism, noting that it "should be treated positively, but Portugal has a formidable adjustment program ahead as it needs to pursue major structural reforms while achieving radical deficit reduction." Jonathan Loynes, the chief European economist for Capital Economics, also evinced mild, cautionary optimism:

> While the confirmation of the bailout should provide some reassurance that Portugal will be able to meet its upcoming bond redemptions, it won't put an end to speculation that — along with Greece and perhaps others — it will sooner or later need to understand some form of debt restructuring.

Another problem is beginning to surface in Portugal as well. Although the country's opposition political parties appear willing to sign on to the deal before the general election date, other EU nations are showing increasing frustration with the bailouts of PIGS. In Finland, for example, the True Finns Party — which could well be part of the new government, to be announced on May 19 — may not favor opening the Finnish checkbook to aid nations that have pursued destructive economic policies and have been less than honest in reporting their economic data. Though socially conservative, True Finns ironically have a socialist leaning on domestic economic issues.

Also, the Social Democrat Party in Finland has already opposed the bailouts of Greece and Ireland. The likelihood, then, that the Finnish government will oppose a bailout of Portugal appears very good. And if Finland does refuse help, then the other EU member states would have to undertake more of the burden.

Many of these nations with stable national credit ratings, such as Finland, have high tax rates to support their social welfare budgets. Bailing out other nations that have been irresponsible with public debt will hurt the social welfare states of the Germans, the Dutch, the Finns, and others. The opposition of the German government, whose support is absolutely crucial, is growing. Government officials announced on May 4, "We are still waiting for information. Given the volume of the deal, the government is well advised to take its time to study carefully the deal to be able to position itself at the European level." German Finance Ministry spokesman Martin Kreienbaum added, "It is important for the German government that firm and strict conditions be formulated." Addressing the Greek bailout, which will come at about the same time, Kreienbaum observed, "It is crucial to find a solution for Greece to put the country's public finances on a permanently stable basis."

Interestingly, European politicians are beginning to talk like officials from separate, sovereign nations — not like leaders of member states within the massive, bureaucratically run EU regional government. When Greek and Portuguese politicians snarl at their German and Finnish counterparts, and when all these politicians have the strong support of their nation's voters — then it would seem as though the dream (or nightmare) of the European Union is quickly unraveling.