Written by Bruce Walker on December 23, 2010

Portugal Rating Downgrade Follows on Heels of Greece Bond Downgrade

Several weeks ago, Greece was on the point of collapse and the European Union needed to bail out the government. In November, Ireland, once the economic dynamo known as the "Celtic Tiger," needed a bailout of its banking system. Earlier this month, it appeared as though Belgium might be the next domino in that economic house of cards which is the European Union. The Euro itself is viewed as facing grave, perhaps insurmountable, problems. Spain and Italy are in serious trouble. Now things seem to be coming to a head. Greece, as reported here by Brian Koenig, faces a downgrade of government bonds from the Ba1 rating by Moody's Investor Service. The confidence level that investors have in the new Greek government appears very low.

Portugal has also just had its credit rating reduced by Fitch Ratings Agency from AA- to A+, reflecting concerns that the government cannot raise money to finance its borrowing. Moody's Investor Services indicated earlier this week that it might reduce its A1 rating by one level or perhaps even by two (which would send a profoundly serious signal to potential investors.) The combined effect of these two highly respected investment services viewing the Portuguese ability to repay public debt negatively will mean that the interest payments required by the government of Portugal — the revenue needed simply to service the debt — will rise. Absent much stronger than anticipated economic growth in the Iberian nation, there is no real light at the end of the tunnel, aside from very rigorous public austerity.

Although Greece, Ireland, and Portugal are relatively small nations (so too is Belgium, who may require a bailout), the steady erosion of confidence in nations of the EU means that the chances of a large nation — Spain very likely and possibly Italy — needing a bailout rise considerably. Not only slow economic growth in other members of the EU, but the broad perception — the accurate perception — that many nations in the European Union have behaved irresponsibly and assumed government debt and government obligations (especially public pensions) which cannot realistically be paid, pulls down general confidence. This is producing more friction within the EU. The German government, which has distanced itself from the problems of less responsible nations, is conspicuously pulling even farther away — rejecting French proposals for more unified economic governance. Germany also faces resentment from other nations, who recall unhappily German efforts at hegemony in the past; now, however, these nations want Germany to pick up the pieces of their public debt woes.

Beyond just doubting the prudence of individual nations in the EU, investors in public debt instruments must, at some point, begin to wonder whether the European Union itself can provide help to many of these nations. There is, inevitably, a "tipping point" at which the ability of the collective known as the

European Union will itself face implosion. Right now, the size of the EU creates the impression of confidence — much as the huge federal government gives that impression in the United States — but no government and no international union of governments is “too big to fail.”

The real question is this: If the European Union itself essentially collapses, how far off will the fall of its constituent nations be? Stay tuned.

Photo: Banco de Portugal

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