Written by Bruce Walker on July 7, 2011

# Portugal’s Government Bonds Now at “Junk” Status

Wednesday, the financial crisis which is threatening all Europe deepened, as the rates for Portuguese government debt instruments jumped higher based upon a decision by Moody’s rating service to reduce those bonds four levels to “junk” status. The drop was from Baa1 to Ba2 on long-term Portuguese bond ratings.

The effect upon Portugal was immediate — but more ominously, in nearby Spain (the fourth of the so-called “PIGS” nations, the others being Portugal, Italy, and Greece), the stock market dropped 1.5 percent and the amount of interest required by bond purchasers rose. Spain’s economy is significantly larger than that of the other PIGS — and only somewhat smaller than the economy of France. Even worse, stocks dropped 2 percent in Italy, affected not only by the ripple of the PIGS but also because spending cuts have not seemed to help its huge national debt.

Bond rating services such as Moody’s sell information, and there is no value to Moody’s in either overrating or underrating securities. Still, the “culprit” in the eyes of many is not the Portuguese spending patterns and government excesses, but rather Moody’s. Fermando Farcia de Olivera, head of the state-owned largest bank in Portugal, called the Moody’s downgrade “immoral and insulting,” while Antonio Sousa of the Portuguese Banking Association claimed it was “incomprehensible.” Bureaucrats of the European Union joined in the Moody-bashing. Amadeu Altafaj Tardio, speaking for Olli Rehn, Monetary Affairs Commissioner for the European Union, declared:

> The timing of Moody’s decision is not only questionable but also based on absolutely hypothetical scenarios which are not in line at all with the economic program. This is an unfortunate episode and it raises once more the issue of the appropriateness of behavior of rating agencies and their clairvoyance.

Charles Diebil, head of market strategy for Lloyds Bank Corporate Markets in London, observed, “The latest rating move on Portugal succeeded in reintroducing a new round of uncertainty, which will support demand for safe-haven assets, at least in the near term.”

According to indexes compiled by Bloomberg and the European Federation of Financial Analysts Societies, Greek government bonds have lost 15 percent of their value and Portuguese government bonds 19 percent. Such negative trends seem certain to make those who wish to invest in these sovereign debt instruments demand much higher interest than they have been receiving. That will mean that these governments will need to cut spending more, raise taxes more, or both. If they fail, then it seems likely that private rating services will be the first to be attacked.

However angry it may make people who work for the European Union or state agencies in these troubled nations, the downward economic spiral continues because these nations have long lived beyond their means. As confidence in the ability of Greece and Portugal (and soon other euro-states) to pay back debt grows, then the interest rates which bond buyers will demand to invest in such bonds will rise. That, in turn, means that interest on bond payments gobbles up an ever higher percentage of government income. Rating services such as Moody's and Standard & Poor's are motivated by cold, hard numbers and not the sway of angry mobs or offended politicians.

The consequences of possible bailouts for nations such as Spain and Italy — whose populations and economies are much larger than those of either Greece, Portugal, or Ireland — is also a grave threat to the European Union. Italian bond yields rose to the highest level since November 2008, and investors saw the problems of the Mediterranean nations of Europe spreading to Spain and Italy. While Italian interest yields rose a relatively modest 11 basis points, Portuguese two-year bonds jumped 155 basis points and Spanish 10-year bonds rose seven points. As the debt interest grows among these European nations, the ability — and the willingness — of more financially prudent governments to provide bailouts seems bound to shrink.

If Spain and then Italy begin to face problems such as those Greece and Portugal are enduring today, there would be no feasible way for Germany and other northern European nations to bail out those much larger economies. The more clearly investors see the general hopelessness of the situation, the more quickly they will dump their sovereign debt and seek instead sure values such as gold or commodities. Given the overall situation in Europe — the entitlement explosion, the political squabbling, the influx of Muslims who dislike their host nations, the rapidly waning luster of the European Union as an economic powerhouse, and the kill-the-messenger mentality toward rating services — things seem certain to worsen in the EU before they improve.

*Photo: Bank of Portugal branch in Oporto*