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a case on public debt management, 2011-2014

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## Restoring Portugal's access to sovereign debt markets, 2011-2014

*"What actually goes wrong involves both the policies that created the vulnerability and the lenders who jump ship." [1]*

On Tuesday April 22nd, 2014, João Moreira Rato was going through the details of Portugal's first sovereign debt auction in three years, due to take place the next day. As the head of the Portuguese debt management office<sup>1</sup>, he felt personally responsible for the success of what the media had dubbed "the ultimate proof" of Portugal's ability to raise money from international investors, since unsustainable interest rates in the spring of 2011 had in effect shut it out from financial markets, forcing it into a rescue loan to avert default.

Portugal's debt management office had, since, been working hard to restore international investors' confidence in the country's creditworthiness. Over the previous two years, João Moreira Rato and his team<sup>2</sup> had had countless meetings with investors, banks, and rating agencies worldwide, to assure them of the Portuguese government's unshakable commitment to honouring its debts. At times of great uncertainty over the country's fate, as was the case during the 2013 political crisis that took the government to the brink of collapse, João Moreira Rato and his team held calls with investors late into the night to provide necessary clarifications. Additionally, they had been conducting a mix of market operations to test and consolidate investor sentiment, in order to gradually rebuild the country's access to markets.

Combined with major institutional developments to strengthen the Eurozone, and with recurrent praise from official creditors for Portugal's commitment to restoring fiscal health, the team's efforts seemed to be yielding results. By spring 2014, Portuguese sovereign bonds were finally trading at pre-crisis levels, indicating a return of investors' confidence in Portugal's creditworthiness. The government agreed this was the best time to move forward with a debt-raising auction - the last step in normalizing access to market funding. However, such an auction was not without risk. Unlike with bank syndicates, the alternate method for issuing debt, the outcome of an auction is less predictable, as banks don't line up orders in advance. Would there be enough demand to place the target amount? Would the bond perform the next day? Portugal couldn't afford to have a weak transaction: the path towards a smooth exit from its bailout programme hinged on it.

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<sup>1</sup> João Moreira Rato was President of the Portuguese Treasury and Debt Management Agency, IGCP in its Portuguese acronym, from to June 2012 to July 2014.

<sup>2</sup> Cristina Casalinho and António Pontes Correia were the other two members of the IGCP's executive team at the time. Decisions by the executive board are customarily made by consensus.

## **The 2011 bailout: domestic vulnerabilities aggravated by a difficult regional context**

*The Eurozone's sovereign debt crisis of 2009-2010*

**Greece: a crisis of confidence** In the wake of the financial crisis of 2007-2008, a sovereign debt crisis emerged in the Eurozone with Greece at its epicenter. In the autumn of 2009, the Greek government revealed that its budget deficit, the amount by which government expenditures exceed government revenues, was not 6.7% of GDP, but 15% - five times the limit established by the Maastricht Treaty. That revelation planted seeds of mistrust towards Greece at the heart of financial markets. Not only did it point to out-of-control public finances - raising fears among holders of Greek sovereign bonds that the country would not make good on its commitments on time or in full [2] - it illustrated "*the lack of quality of the Greek fiscal statistics*", the European Commission observed in a report [3]. For sovereign debt markets, an industry where reliable and verifiable information is at the heart of multi-million euro decisions, this was a grave offense. Investors' confidence - the "*unobservable variable*" [4] that can make or break a deal - was shattered. It didn't help that Greece suffered from "*poor competitiveness, foreign investment, productivity and employment records*" [5], nor that its government's debt-to-GDP ratio was one of the highest in Europe.

With investors demanding an ever-increasing premium for holding Greek bonds to compensate for the risk that they wouldn't be repaid, Greece found itself locked in a vicious cycle where rampant borrowing costs compromise a country's ability to honour its financial obligations, thus pushing the risk premium up, prompting rating agencies to downgrade the sovereign's credit rating, in turn pushing borrowing costs up again - and on and on. In fact, it was only a matter of months until the world's three largest credit rating agencies<sup>3</sup>, whose role is to certify credit quality, brought Greece's long-term credit rating down to speculative grade, indicative of "*an elevated vulnerability to default risk*" [6]. It was the first time ever that the "junk status" typically associated with poor, unstable, emerging economies was to be found at the heart of one of the world's most advanced economic regions. This sent shockwaves across the financial world, and set the genie free: if one member of the Eurozone could fall, so could others. [7]

**Vulnerabilities abound** Other members of the Eurozone had built up economic and fiscal fragilities over the years. The region as a whole had underperformed over the past decade [8] (Exhibit 1) and, "*by the end of 2010, debt-to-GDP ratios in most euro area countries and the euro area as a whole exceeded the 60% reference value*" imposed by the Maastricht Treaty [9]. Financial markets had, thus far, overlooked those vulnerabilities because Eurozone membership, and the fiscal corset attached to it, acted as a seal of credit quality. "*Before the sovereign debt crisis, most investors, and also credit rating agencies, weren't paying attention to the fundamentals of each member of the*

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<sup>3</sup> Standard and Poor's Financial Services, Fitch Ratings, Moody's Investors Service

*Eurozone. Everyone benefited from good ratings and easy financing*", a banker explained. But hesitations around the type of support the Eurozone would offer to Greece shattered the status quo [7]. Speculation on the fate of Eurozone countries with the poorest economic and fiscal fundamentals was set loose, and, despite their differences, Greece, Italy, Ireland, Spain, and Portugal all faced higher borrowing costs as financial markets demanded a premium to compensate for the risk of a Eurozone breakup [10]. (Exhibit 3)

**Greek and Irish bailouts** Greece ultimately avoided a chaotic default by obtaining a €110 billion bailout package in May 2010 from the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF), in exchange for a tough austerity programme. Six months later, the Irish Republic followed suit, though for reasons very distinct from Greece's, obtaining a €85 billion loan from the institutions forming the so-called "troika"<sup>4</sup>. And despite the Portuguese government's repeated attempts to convince markets that "Portugal was not Greece", it was only a matter of months until it found itself increasingly shut out of financial markets, and unable to service its debt.

*Portugal's predicament: large economic imbalances and external borrowing requirements*

**Debt as a way of life** Portugal registered the slowest growth rate in the euro area after Italy from 2000 to 2010<sup>5</sup>. Its external competitiveness deteriorated over the same period, and productivity growth was "disappointing"[11]. The massive and growing deficit of its current account, a measure of national savings, indicated that the economy consumed more than it produced - something that was made possible by the fact that Portugal's participation in the Eurozone had greatly increased the country's access to cheap, foreign capital<sup>6</sup>. (Exhibit 2)

The government also lived off debt. Like other Eurozone members, Portugal had been running budget deficits for decades (Exhibit 4). Its last balanced budget dated back to 1970. Consequently, total government debt, i.e. the accumulation of past borrowing, increased sizeably over time. [12] Most worryingly for bondholders, debt had in recent years exploded from 68.4% of GDP in 2007 to 96.2% in 2010 - "*levels deemed hard to rein back without debt restructuring*", the Financial Times reported [13]. (Exhibit 5)

**A narrow investor base** At the end of 2010, over 70% of Portuguese public debt was held by non-resident investors, primarily European [14]. Most were "real-money" investors, i.e. central banks, insurance companies, pension funds, and asset management firms that typically invest

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<sup>4</sup> As in a kind of "puzzle-superstructure", where apparently unconnected variables lead to the same outcome (Duarte Pitta Ferraz)

<sup>5</sup> Calculated as the average of GDP growth from 2000 to 2010. The initial members of the Eurozone were considered (Italy, Germany, France, Netherlands, Austria, Belgium, Finland, Spain, Ireland and Luxembourg) + Greece (joined in 2001). Based on World Bank data.

<sup>6</sup> Portugal's borrowing costs came down by approximately 46% after it joined the Euro.

in low-risk government bonds of developed markets<sup>7</sup>. Conservative by nature, these investors are mostly restricted to carrying assets that are highly rated by at least one of the three recognized credit rating agencies. The base of investors in Portuguese government securities was therefore little diversified, both in terms of nationality and type of investor. And, as Portugal would soon find out, that made it very exposed to funding shocks because "*investors who share the same incentives (...) tend to act in unison, amplifying market volatility*" [15]. Additionally, the confidence of foreign creditors tends to be more fickle in a crisis than that of domestic investors, who have more information on the course of national events<sup>8</sup>.

### *The tide turns*

**Credit risk** With turmoil spreading across the region, Portugal's "*chronic low growth, drastic loss of competitiveness, and high public and private indebtedness*" [16] looked ever more ominous. As markets increasingly saw in Portugal's bonds a credit risk, i.e. the possibility that they would not be paid back in full or in time, interest rates demanded by investors to lend money to Portugal rose steeply (Exhibit 6). The loss of confidence in Portugal's creditworthiness was simultaneously confirmed and reinforced by the actions of credit rating firms. Between March 2010 and March 2011, the world's three largest credit rating agencies successively downgraded Portugal's rating, bringing it down to only a few levels above junk territory, adding pressure to the country's cost of funding (Exhibit 7). In April 2011, the risk of a Portuguese default was being "*priced in the markets at a probability of 40 per cent*" [13]. It was Portugal's turn to be locked in the "downward spiral" that had pushed Greece and Ireland out of financial markets. [17]

**Rollover risk and sudden stop** With costs of borrowing surging, investor confidence floundering, and rating agencies poised to downgrade the country's credit rating to "junk", Portugal's ability to obtain funding from international financial markets was abruptly curtailed. This posed an immediate problem: Portugal had to rollover approximately €22 billion in government bonds in the following 12 months [18]. With most investors looking to reduce their exposure to the Portuguese market, it became increasingly difficult for the authorities to raise the cash they required to honour imminent financial obligations. As in past cases where countries with high external borrowing requirements faced acute liquidity crisis, the major threat to Portugal's solvency came from its newfound incapacity to rollover debt, i.e. issue new bonds to replace maturing bonds [19]. "*When we speak about public debt, we tend to focus on the stock*", said Cristina Casalinho, an economist and member of the board of the Portuguese debt management office. "*It's at the margin, though, that issues usually come up*". For a country whose private and public sectors were highly dependent on

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<sup>7</sup> Central banks, asset managers, pension and insurance funds represented on average 60% of investors in primary issuances between March 2008 and February 2010. IGCP data.

<sup>8</sup> The differences in owing money to foreign or domestic lenders are addressed both by Carmen M. Reinhart and Kenneth Rogoff in *This time is different*, and D. Hartwig Lojsch, M. Rodriguez Vives, and M. Slavik, in "The size and composition of government debt in the euro area".

external sources of financing, the possibility of a "sudden stop"<sup>9</sup> of international credit inflows amounted to a near-death experience. Options were limited: default on debt, and suffer the consequences of becoming an international financial pariah; or resort to international aid, and be subject to the harsh medicine of official creditors.

**The third bailout** Hardly a desirable outcome, sovereign default was potentially even more dramatic for a country in a currency union, as the destabilizing effects on other members were unpredictable. On April 7, 2011, Portugal formally requested an international rescue package of €78 billion from the EC, the ECB and the IMF. The disbursement of funds was conditional on the implementation of austerity policies and structural reforms due to "*restore sound public finances, improve competitiveness and put Portugal's economy back on the path of sustainable growth and job creation*"[20]. With that loan, Portugal's medium and long-term financing needs were covered until September 2013. It had to find its way back to markets by then.

**"Le coup de grâce": junk rating** Although hardly a surprise, the final deathblow came a few months later when, in July 2011, the rating agency Moody's downgraded Portugal's credit rating to speculative grade, albeit with recognition that Portugal's debt faced "*a much lower risk of restructuring than Greece's*"[21]. Still, the agency's opinion was that the "*likelihood that Portugal will soon be able to regain market access on sustainable terms*" was slim. Fitch and S&P followed suit shortly thereafter and, by early 2012, only a second-tier rating agency deemed Portugal's bonds to be investment grade (Exhibit 7). This had consequences greater than hurting the country's self-esteem, already at a low point. It meant that Portuguese sovereign bonds were dropped from low-risk, influential bond indices replicated by many of Portugal's traditional bondholders, forcing them to liquidate their positions for regulatory reasons. As a result, during the first eight months of 2012, there was a net reduction of debt held by non-residents of more than €1 billion per month. [22]

Given the limitations of having a non-investment grade, Portugal needed to actively find new investors if it was to rebuild access to financial markets. That was a tall order for a country that had just resorted to its third financial rescue in 30 years<sup>10</sup>. As he took on the leadership of the Portuguese debt management office in June 2012, João Moreira Rato was given an unambiguous mandate: cultivate relationships with private investors, and restore access to external funding.

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<sup>9</sup> A term popularized by Italo Calvo and originally used in R. Dornbusch, I. Goldfajn, and R. Valdés' paper: "Currency Crisis and Collapses", Brookings Papers on Economic Activity, 1995

<sup>10</sup> Portugal resorted to loans from the IMF in 1978-79 and 1983-84.

## Winning back investors

*June-September 2012: defining the overall strategy*

For João Moreira Rato, a Chicago-trained economist with more than 10 years' experience in investment banking, resetting the country's credentials as a credible sovereign issuer was a process. It would involve finding the right investors, and persuading them that the "*high yields of his country's government bonds were in fact an opportunity to enhance profits, rather than a risk for future losses*" [23]. His mission would be accomplished once Portugal's access to markets was normalized, meaning it could, once again, issue medium and long-term debt<sup>11</sup> via a mix of bank syndicates and auctions.

**It takes two to issue debt** By definition, issuing debt is a two-way transaction. The first step to restore access to markets was therefore to find investors willing to lend money to the Portuguese government, and address their central question: "*will I get repaid?*" [24]

With Portuguese government securities now being traded in high-yield, high-risk, emerging market funds, credit risk was at the forefront of investors' concerns. The government's line was unequivocal: it would honour all of its current and future debts. The rigorous implementation of the austerity cure it had signed up to as a pre-condition for its international rescue loan was to be understood as a firm commitment to getting its house in order. So much so that Portugal quickly earned a reputation for being the "*Eurozone's good pupil*", after official creditors repeatedly praised the authorities' determination "*to stay the course of adjustment and reform*"[25].

This was already being reflected in yields of Portuguese long-term bonds, which had decreased significantly since peaking in January 2012 (Exhibit 6). That downward trend was reinforced after the President of the ECB pledged in July 2012 to do "*whatever it takes to preserve the euro*"[26], effectively tightening the Eurozone's safety net. Investors had little apparent reasons to feel edgy about Portugal. Still, Mario Draghi's commitment had yet to be tested, and woes from Greece's sovereign debt restructuring earlier that year were vivid. Not only had it "*set a new world record in terms of restructured debt volume and aggregate creditor losses*"[27], it had torn apart the belief that no member of the Eurozone could ever default on debt<sup>12</sup>. Investors worried: could Portugal be next?

In such a scenario, actively reaching out to investors to provide assurances that Portugal *could pay, wanted to pay*<sup>13</sup>, and *would pay* was critical. Over the course of the following twenty months, João Moreira Rato and his team would travel, sometimes as frequently as 3 times per month, to meet investors all over the world; offer information; provide clarifications; and develop a first-hand feel of the market's sentiment towards Portugal.

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<sup>11</sup> Most common maturities for medium and long-term debt bonds are 5 and 10 years. Short-term debt, to which access was less disrupted, can be issued in 3, 6, 12 or 18 month notes.

<sup>12</sup> Default here is understood in its wider definition, including debt restructuring.

<sup>13</sup> In *This time is different*, Carmen M. Reinhart and Kenneth Rogoff argue that willingness to pay rather than ability to pay is typically the main determinant of a country default [28].

**A consistent narrative based on sound data** Portugal's sovereign bonds now posing credit risk, the financial community's level of vigilance and scrutiny of government accounts and statistics was more intense than before [9]. And while João Moreira Rato had no control over the course of the government's fiscal and economic policies, he was convinced that transparency and predictability would go a long way in Portugal's difficult path back to markets. To ensure that investors were clear about his country's commitment to reining in debt levels and restoring economic growth, João Moreira Rato and his team put together a 50-slide presentation to investors in the language that markets know best: tables, figures, and charts. Entitled "Portugal: shifting the economic paradigm", it presented a narrative of fiscal consolidation, structural reforms, and export-led growth. Most importantly, it was backed up by credible statistical sources. (Exhibit 8)

**Active debt management** Improving market sentiment also required that the other dimension of debt sustainability, i.e. liquidity, be addressed. In fact, "*demonstrating the government's ability to rollover maturing debt in an orderly manner*" was just as important to win back investors' confidence [9]. And while João Moreira Rato couldn't act on the debt stock, there were three ways in which he could alter its composition to reduce vulnerability to rollover risk, i.e. the risk that interest rates rise adversely when the government needs to obtain money from the markets. The first was to extend the maturities of outstanding debt so that reimbursements would be spread out over a longer period of time. This would be achieved via bond exchange operations. The second was to raise cash buffers such that available finances were, at any given point, enough to cover maturing liabilities of the following twelve months, thus allowing Portugal to stay out of the market during periods of heightened turmoil. The third was to broaden the investor base to dilute the risk that similarly-minded investors pulled out of the market at the same time.

*September - December 2012: baby steps*

**First results** Initial signs that the government's austerity programme was delivering the expected results came towards the end of the summer of 2012. On the fiscal consolidation front, the government was expected to meet the 5% of GDP budget deficit target for 2012, down from 9.8% in 2010 [29]. Troika calculations pointed to a fiscal primary surplus already in 2014 [29], the first since 1997. This was welcome news: with a primary surplus the government doesn't need to borrow more money and can reduce its debt stock, given that it can pay for all of its expenditures (excluding interest paid on debt) with income from taxes. Additionally, by the third quarter of 2012, the government had already cashed in more than €3 billion in the sale of state-owned companies, boosting the budget on the revenue side.

On the growth front the picture was more nuanced. As the member of a currency union, Portugal's main available tools to stimulate economic growth and restore competitiveness were structural reforms. And various parts of the economy, most notably the labour market, were indeed

being overhauled. However, potential benefits from those reforms would only be visible in the medium-term. In the short-term, they came at a cost: GDP growth was negative since the first quarter of 2011, and, at 15.8%, unemployment had never been so high. (Exhibit 10)

Still, there was a much-prized silver lining. A "*remarkable export performance*" had pushed the share of exports in GDP up from 28% in 2009 to 38.7% in 2012. "*As a result, the current account deficit fell from more than 10% in 2010 to under 2%, and was projected to be balanced in 2013 for the first time in more than 40 years*", the European Commission observed [30]. This was definitely something worth telling investors about.

**Staunching the bleeding** Armed with his presentation, his credentials as a financial markets' insider, and the government's blessing, João Moreira Rato and his team set out to meet with investors as of September 2012. The first foreign investors they met with were German and French asset managers who had retained part of their investment in Portuguese sovereign securities despite the country's descent into non-investment grade. They hoped to convince them to stick to their Portuguese bonds, so that volatility, which pushes yields up, would decrease.

Signs that Portugal's austerity cure was delivering the desired results encouraged bondholders. A timely statement from Portugal's official creditors declaring "*the public debt-to-GDP ratio (...) remains sustainable and will be on a firm downward trajectory after 2014*" [31] strengthened João Moreira Rato's case. Still, investors remarked that Portugal had a long way to go, and wondered if the government's commitment to austerity wouldn't be short-lived, given unemployment figures and mounting public discontent.

**Acceptance for austerity no more?** The autumn of 2012 was in fact marked by large-scale demonstrations against the government's budget-cutting programme (Exhibit 9). Portuguese citizens who had, until then, "*patiently endured [the government's austerity policy] with little of the popular outcry seen elsewhere in southern Europe*"[32], were taking to the streets. Investors worried: major losses had been imposed on Greece's bondholders after protests derailed that country's government from the austerity track. Would the Portuguese too, yield to pressure from the street?

João Moreira Rato and his team didn't have definite answers. They presented their views on the underlying factors behind the demonstrations, and shared insights on the country's social structure. They pointed out that the government enjoyed an absolute majority in Parliament, and that there were no indications of serious threats to the establishment from fringe political parties. They were, nonetheless, realistic in their presentations about the challenges of the adjustment Portugal was going through and the risks associated with it. In fact, João Moreira Rato and his team always strived to provide investors with as full a picture as possible to limit the odds that their interlocutors be caught off guard by negative developments.

Social unrest eventually subdued, and the government stayed on track. A few weeks later, the troika put out a statement declaring that "*a broad political and social consensus continues to be an important asset for the success of the programme*" [33].

**October 3rd: first bond exchange** Observing favourable market conditions in early October, the debt management office proceeded with its first exchange operation to elongate the period over which debt was due to be repaid. It swapped €3.75 billion worth of bonds maturing in September 2013 for the same amount of bonds maturing two years later, thereby simultaneously bringing the level of redemptions due in 2013 to a more manageable level, and signalling improved levels of investor confidence in Portugal's ability to reimburse debt in the medium term. This was an important first step in regaining market access. In fact, only creditors who trust that the issuer remains solvent and liquid will agree to delay to moment when they get their money back.

### **2013: the roller-coaster year**

*January-June 2013: the quiet before the storm*

**A good start** With the New Year came improved market conditions for peripheral Eurozone countries. Institutional support mechanisms such as the European Stability Mechanism and the Outright Monetary Transactions programme were now effectively in place, and Eurozone leaders expressed unwavering resolve to preserve the currency union. As return-chasing investors reappraised the risks of owning securities from distressed Eurozone members, several peripheral countries issued debt early that year to take advantage of lower borrowing costs [34]. Portugal also moved fast to reap the benefits of improved market conditions. With a successful exchange operation to their credit, and improving macro-economic indicators, João Moreira Rato and his team were confident the moment had come to issue new debt.

**Finding new investors** Portugal's credit rating below investment grade meant, however, that the pool of investors they could turn to was limited. They needed to find more investors who'd have the flexibility to buy speculative-graded debt, and who'd understand the gains to be made from bonds of a country going through a fiscal and economic adjustment programme like Portugal's. Investors of the sort were, for a large part, across the Atlantic. And although American investors had typically shown little interest in Portuguese bonds, secondary market transactions of the last quarter of 2012 revealed a larger than usual American appetite for Portugal government securities<sup>14</sup>. This was clearly the right moment to court American investors: João Moreira Rato picked up the phone, and started making arrangements for his first American roadshow.

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<sup>14</sup> Source: IGCP

In the second half of January 2013, he and his team<sup>15</sup> met with dozens of investors in Los Angeles, San Francisco, Boston and New York City, many of whom were familiar with similar cases in Latin America. They knew where to look for signs of success in the macro-economic data João Moreira Rato had brought to them, and they were particularly impressed with Portugal's export performance. For a country whose economy hadn't grown in a decade, the speed with which exports had picked up since the crisis was remarkable, and definitely a cause for confidence in the country's ability to kick-start the economy (Exhibit 10). Portugal's export performance was all the more interesting that it presented a highly diversified profile, both in its sectorial composition and geographic distribution, making it more robust to fluctuations of demand in trading partners.

**January 23rd: first 5-year bond issuance** Upon returning from the USA, João Moreira Rato and his team executed the country's first major operation in medium and long-term markets since 2011. On January 23rd, they issued €2.5 billion worth of 5-year bonds via a bank syndicate, i.e. a group of banks that builds a "book" of orders indicating how much each investor is willing to lend to the issuer, and at what price. Despite being more expensive than an auction due to bank fees, opting for a syndicate gave the debt management office more guarantees of success and control over the allocation of bonds. When the book closed with nearly 300 orders adding to more than €12 billion, indicating a very sizeable interest in Portuguese government securities, João Moreira Rato and his team went through them one by one. Ideally they'd want to have as large a proportion as possible of "real-money" investors because *"they provide a more stable source of demand for government debt"*[35], and, by limiting volatility, they would contribute to lowering yields. Still, they were realistic about current market conditions, and recognized that Portugal's profile as a high-risk, high-yield issuer was more in line with the type of investment opportunities sought after by hedge funds, more likely to quickly resell the bond in the secondary market and with that increase volatility. In the end, more than 60% of the bonds were allocated to "real-money" investors and 24% to hedge funds. Their American roadshow had paid off: 34% of investors were from the USA - the highest ever participation of American investors in a Portuguese debt issuance -, 28% from the UK, and less than 20% from other European countries. This represented a significant shift from Portugal's traditional investor base and a strong sign that the country's credibility as a competent and trustworthy sovereign issuer was being restored. João Moreira Rato was feeling confident: *"I expect we will have full market access in the next few months,"* he told the Financial Times a few weeks later [36].

**May 7th: the first 10-year bond issuance** Observing favourable market conditions once again in mid-spring, the Portuguese debt management office proceeded with the year's second issuance. On May 7th, it raised €3 billion worth of 10-year bonds, with demand exceeding 3 times the offer. This issuance was another milestone in the country's path back to markets: it was the first time

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<sup>15</sup> On this particular roadshow, João Moreira Rato and his team were joined by the government's Secretary of State for Treasury.

the country issued a 10-year bond since its bailout. This was a signal that confidence was consolidating, given that longer maturities command higher levels of trust. Geographic distribution was wider than that achieved in the January issuance. The participation of 10% of investors from Scandinavia was particularly noteworthy, although non-coincidental: João Moreira Rato and his team had recently been on a roadshow in Scandinavia where they'd gone guided by the imperative of broadening the investor base.

**Good prospects** Portugal was undoubtedly on the right track back to markets. With two successful bond issuances to its credit; a substantial cash buffer [30]; continued support from Eurozone authorities; and a revision by a rating agency for the country's sovereign rating outlook from negative to stable [37], prospects couldn't be brighter. By the end of May 2013, Portugal's 10-year bonds were trading at pre-crisis levels.

#### *A very hot summer*

Early July 2013, there was, however, a brutal reversal of tide. Investors started frantically calling João Moreira Rato when international news channels reported possible snap elections in Portugal following the resignation of two high-profile ministers, including that of the head of the government's junior coalition partner. Was the government about to collapse?

While the government quickly provided assurances that it would hold steady, uncertainty lingered on for weeks, amplifying investor nervousness. João Moreira Rato and his team held innumerable conference calls with investors who were at a loss after having participated in the May issuance, especially that the word out in international media was that Portugal was bound to require a second bailout [38], and that private creditors would incur losses [39]. João Moreira Rato and his team helped investors see beyond sound bites by laying out possible scenarios; keeping them up to date on the latest developments; and offering various other sources of information. A few investors sold, others didn't. In the process, yields on 10-year government securities jumped to levels close to those at which Portugal had been forced into the bailout two years earlier. (Exhibit 6)

The government's plans to be fully back to markets in the fall of 2013 were crushed. The country's Constitutional Court decisions in late August and mid-September striking down, once again, some of the government's planned budget cuts as anti-constitutional, only drove down the nail into the matter.

#### *Autumn 2013: back on track*

**Renewed optimism** By November, the dust had settled down. Reviews of Portugal's economic adjustment programme by official creditors were positive, and yields on long-term securities resumed the downward path initiated before the summer. The regional context was also favourable. Ireland was due to make a "clean" exit from its bailout programme before the end of the year, meaning

that it wouldn't resort to the safety net of a newly-created official credit line designed to shelter fragile Eurozone members from market turbulence. [40] Ideally, Portugal would want to emulate Ireland's exit, even more so that conditions attached to that special credit line hadn't been specified, and some investors worried it might involve losses for private bondholders. Portugal's "clean" exit from the programme would only become a plausible scenario, however, once the country had fully normalized its access to markets. That implied conducting regular debt-raising auctions, for which conditions didn't exist - yet.

**December 3rd: second bond exchange**      Something impactful and yet prudent had to be done to trigger a virtuous cycle of confidence in Portugal's ability to go without further official support. On December 3rd, the debt management office swapped €6.5 billion worth of bonds maturing in 2014 and 2015 for bonds due in 2017 and 2018. This operation, namely because its volume surpassed many times market expectations (it amounted to nearly twice that of bonds exchanged in October 2012), confirmed that Portugal's access to markets was robust, and paved the way to its smooth exit from the bailout programme.

## **2014: back to normality?**

*January-March 2014: Preparing the exit*

**Back to markets**      In anticipation of the best moment to take "the final plunge", the debt management office conducted two syndicated operations in January and February. The work João Moreira Rato and his team had carried out in the past 12 months to diversify the base of investors and lower bond volatility was bearing fruit. Relative to the 5-year bond issuance of January 2013, the first issuance of 2014 attracted a lesser percentage of hedge funds, which now accounted for only 7% of investors versus 24% in 2013 - a level on par with that observed before the crisis. The upping of Scandinavian participation in the second issuance of 2014 was also noteworthy, as was the return of investors from Benelux who, once a fixture in Portuguese sovereign debt issuances, had gone missing since the beginning of the crisis. These were strong indications that Portugal's access to markets was returning to normality.

**An improved outlook**      Portugal's economy and public finances also presented a markedly different profile from 3 years earlier. After having contracted for eleven consecutive quarters, GDP had finally grown 1.03% in the last quarter of 2013 [40]. The unemployment rate was on a downward path since the second quarter of 2013, although from very high levels [41]. (Exhibit 11) Private consumption and investment were picking up [41], and the economy's export performance was going strong. The government had executed an ambitious plan of privatizations of state-owned companies that generated in excess of €8 billion.

Structural reforms aimed at restoring the country's competitiveness had left hardly any sector of the economy untouched. Substantial changes had been made to the judicial system, the housing sector, the services sector, network industries, energy, and competition law. Unit labour costs - identified by the troika as one of the factors undermining the economy's competitiveness during the 2000s [40] - had decreased by 3.4% relative to 2010<sup>16</sup>.

On the fiscal front, the country's official creditors qualified the government's effort to reduce large imbalances as "impressive"[41]. The general government deficit was more than halved between 2010 and 2013, from 9.8% to 4.5% of GDP. A much-anticipated primary surplus of 0.1% of GDP had been recorded in 2013<sup>17</sup>, and projections pointed to an ever better performance of public finances in the year after.

Still, at 130% of GDP, Portugal's government debt was one of the highest in Europe, and implied "*large debt rollover needs in the coming years*" [41]. And with the end of the programme in sight and austerity fatigue taking hold, some observers questioned whether Portugal had made enough structural reforms to generate the growth necessary to "*meet its big debt and unemployment challenges*"[42].

**Confidence returns** In spite of those fragilities, confidence in Portugal's creditworthiness seemed to be back for good. After having bottomed in 2012, the amount of Portuguese government debt securities held by foreign investors was rising<sup>18</sup>. The external environment played its part. There was renewed optimism in the Eurozone periphery, and the global environment was characterized by low interest rates, making the Eurozone's periphery yields even more attractive. The ECB was considering embarking on "quantitative easing" programme [43], offering additional tranquillity to investors.

João Moreira Rato and his team's debt management strategy had also borne fruits. "*The accumulation of a significant cash buffer and the carrying out of buy-backs to improve the maturity profile have helped improve the country's funding outlook*"[44], a rating agency observed. In fact, with the two issuances carried out earlier that year, the debt management office had already raised enough money to see if through part of 2015 if necessary. And Portugal's bond redemption schedule was also much improved: in only three years, the average debt maturity of Portugal's sovereign debt had been extended from 5,7 years to 7,5 years<sup>19</sup>.

"*Doing an auction while the patient was in intensive care would have been too risky: we just couldn't afford to have a failed operation*", António Pontes Correia, a board member of the debt

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<sup>16</sup> Source: OECD

<sup>17</sup> Source: Bank of Portugal

<sup>18</sup> Source: IGCP

<sup>19</sup> Source: IGCP

management office explained. *"But once our condition became more robust, the Board was unanimous: the time had come to take the final plunge."*

*April 2014: the last step in normalizing access to markets*

Portugal's previous long-term bond auction dated back to January 2011, months only before the country resorted to its international rescue loan. At the time, the government had paid an average interest rate of 6.716 % to issue 10-year bonds. Portugal's long-term bonds were now trading below 4% on secondary markets, close to the level at which Irish bond yields were before Ireland exited its own bailout programme. The premium investors demanded to hold Portuguese bonds relative to German bonds was the lowest it had been in years. Having just met with investors in the UK and Scandinavia, João Moreira Rato and his team trusted there was enough investor appetite for Portugal's first sovereign bond auction in years to succeed.

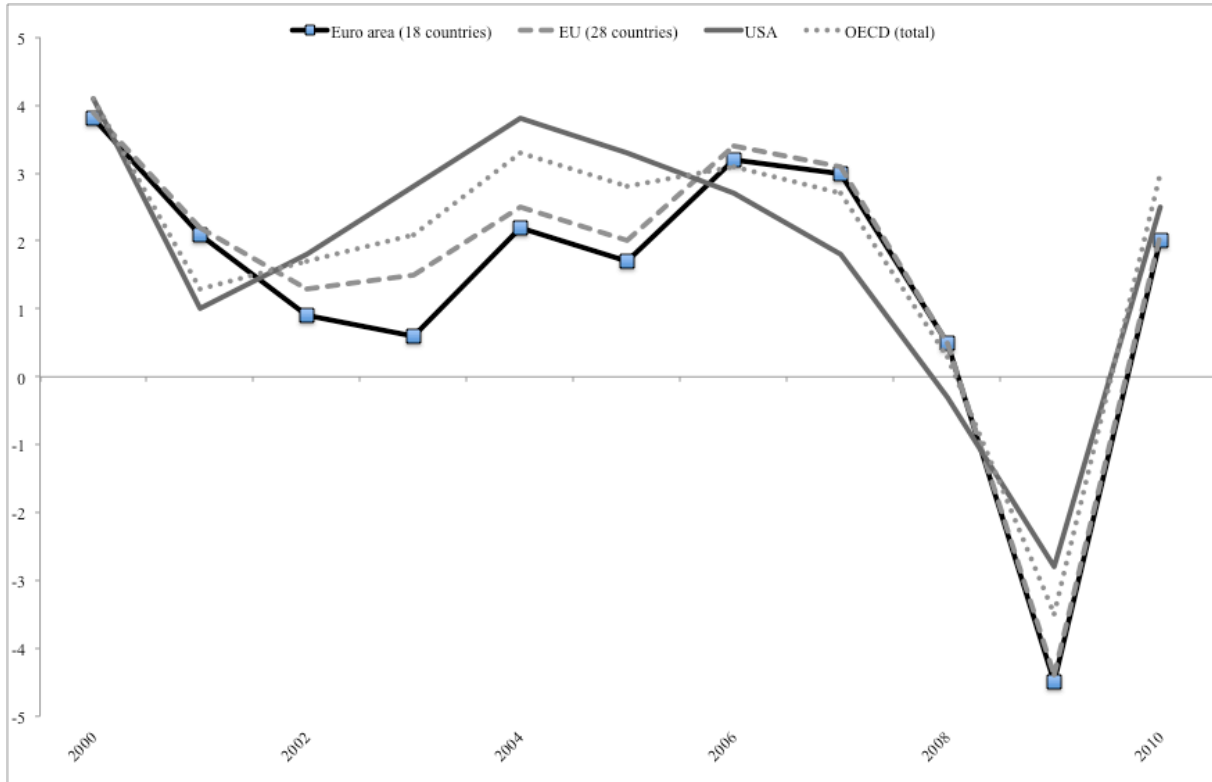
Still, they'd have a lot less control over the outcome than with bank syndicates. In an auction, "primary dealers", i.e. financial intermediaries authorized to purchase bonds directly from the debt management office to then resell them to investors, run the show. Their performance was so critical that João Moreira Rato convened a meeting in the solemn setting of the Portuguese Embassy in London a few days in advance to take them through the details and set high expectations.

Would primary dealers place enough offers to reach the target amount? Would they demand a price in line with secondary market yields? Would they inflate their prices and with that distort market expectations? How would the bond perform the next way? Most importantly, would this bring one of Portugal's most painful moments in recent history to a close?

João Moreira Rato, his team, and the rest of the country would find out soon enough.

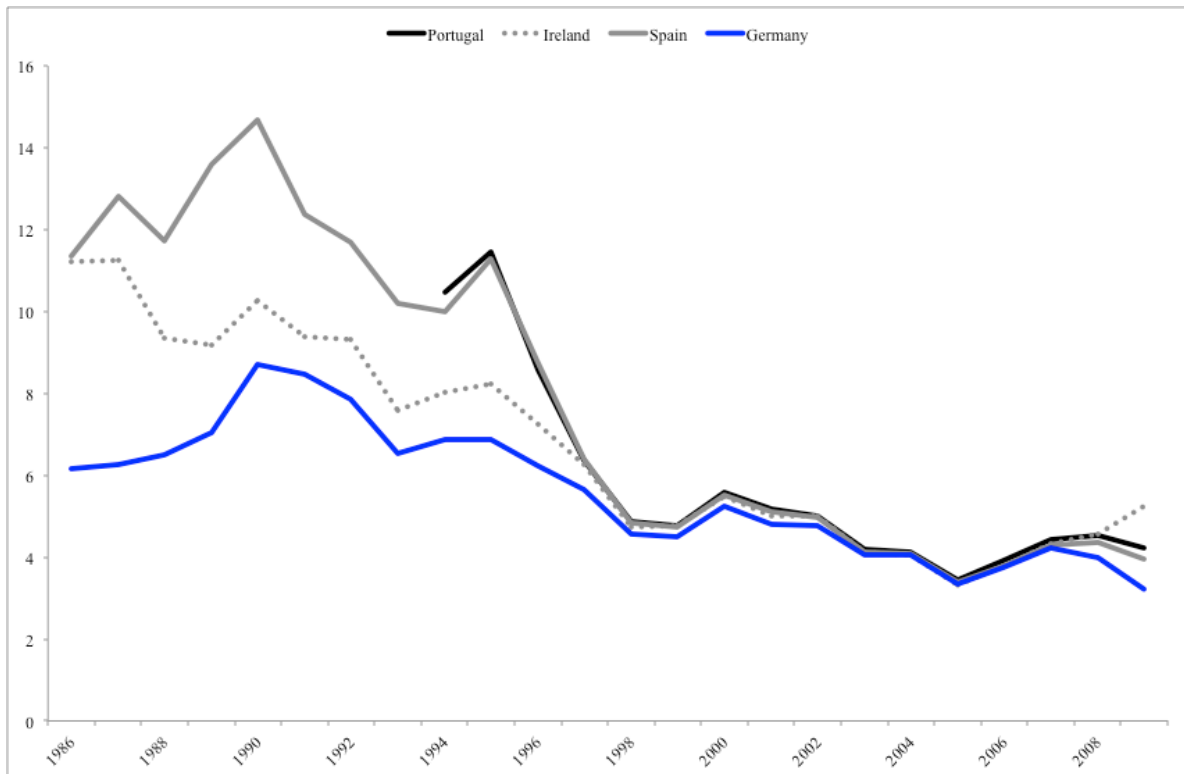
**Exhibit 1: GDP growth of selected advanced economic regions, 2000-2010**

Source: OECD



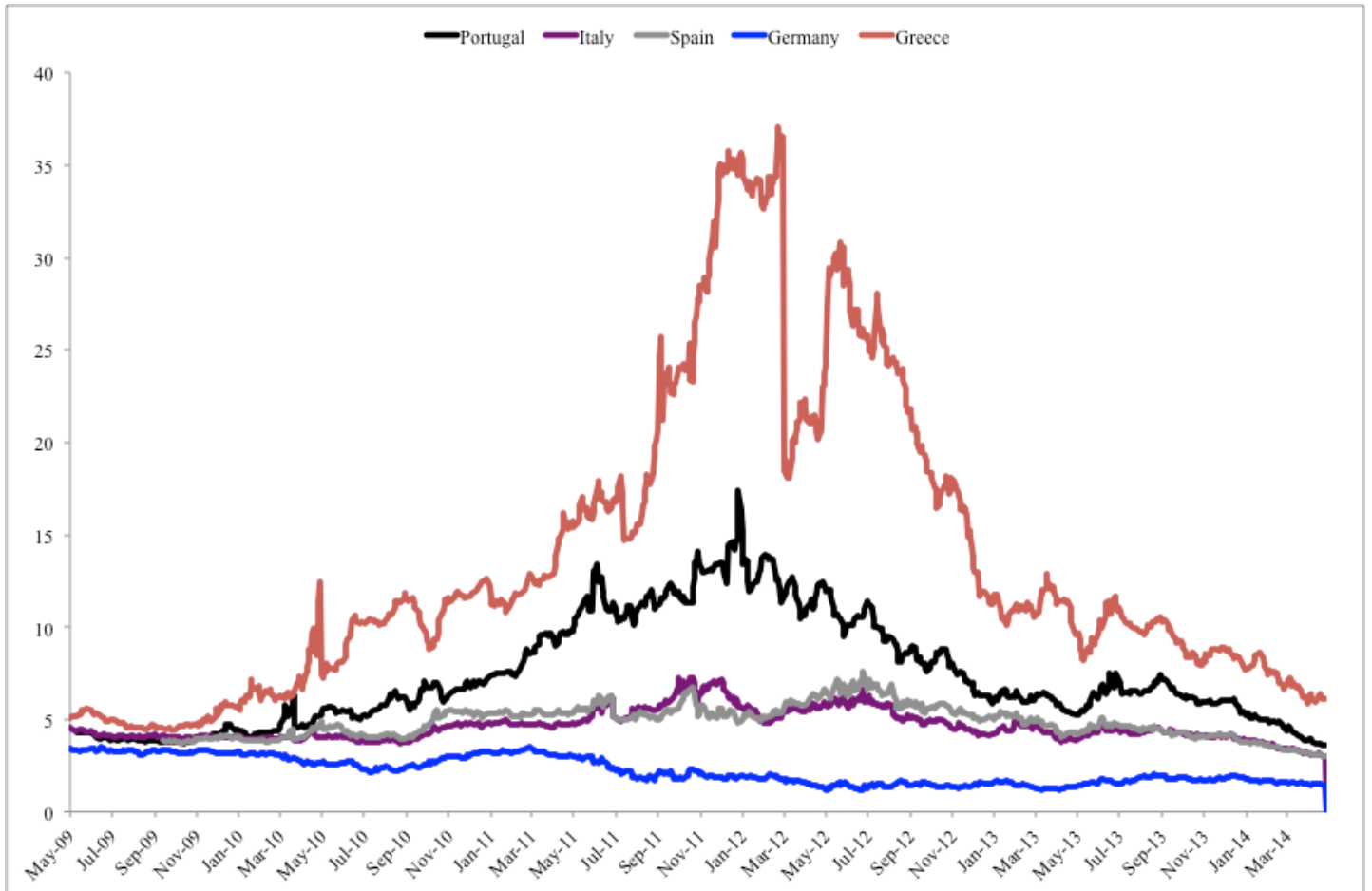
**Exhibit 2: Long-term interest rates of 10-year bonds of selected Eurozone members, 1986-2009**

Source: OECD



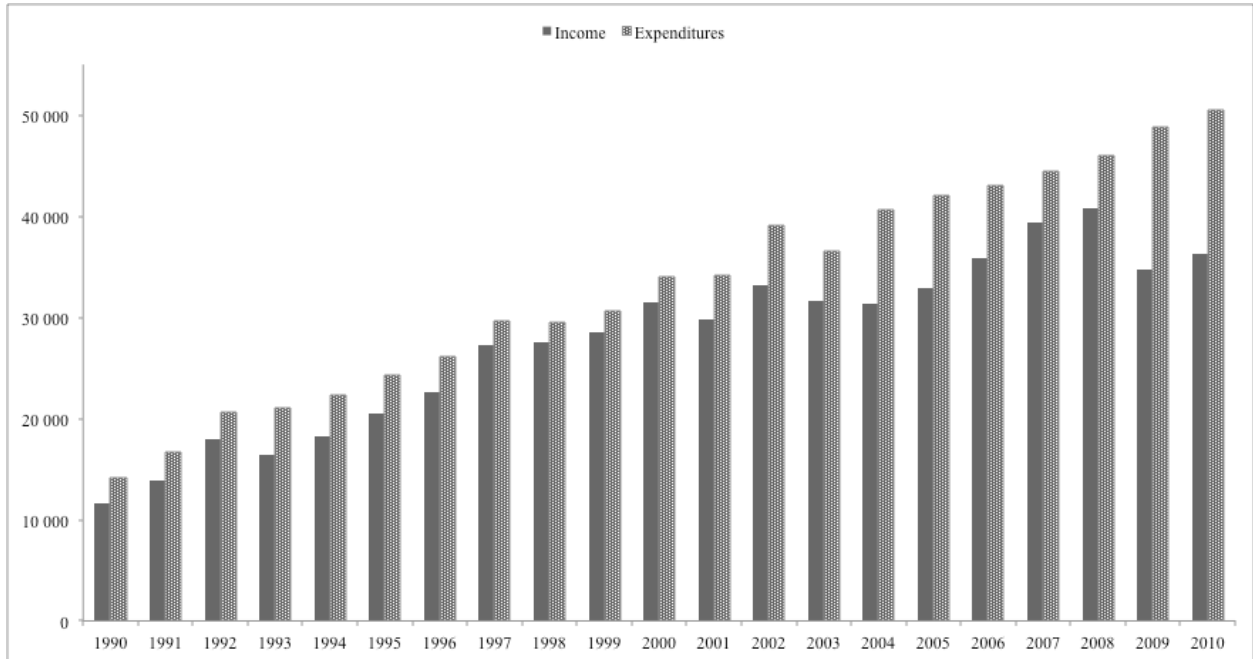
**Exhibit 3: Yields of 10-year government bonds of selected Eurozone members  
May 2009-April 2014**

Source: Bloomberg



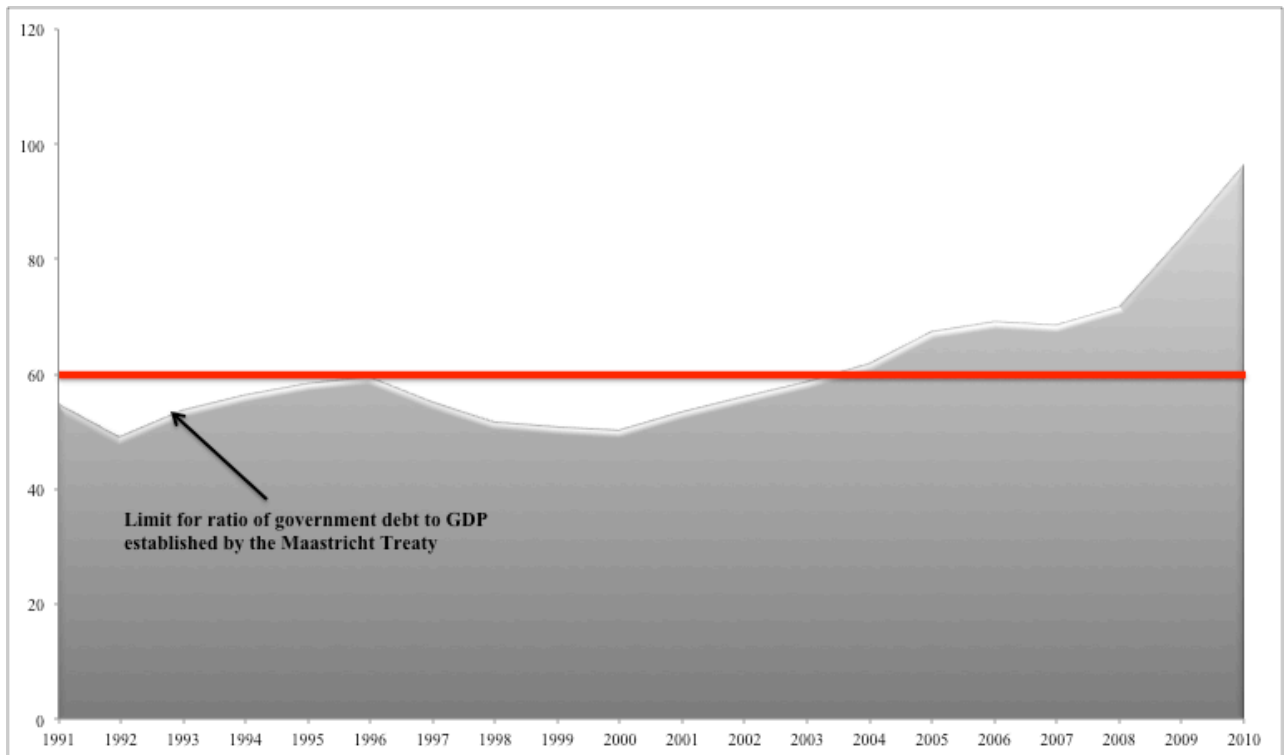
#### Exhibit 4: Income and expenditures of the Portuguese State, 1990-2010 (in millions of €)

Sources: PORDATA and IGCP



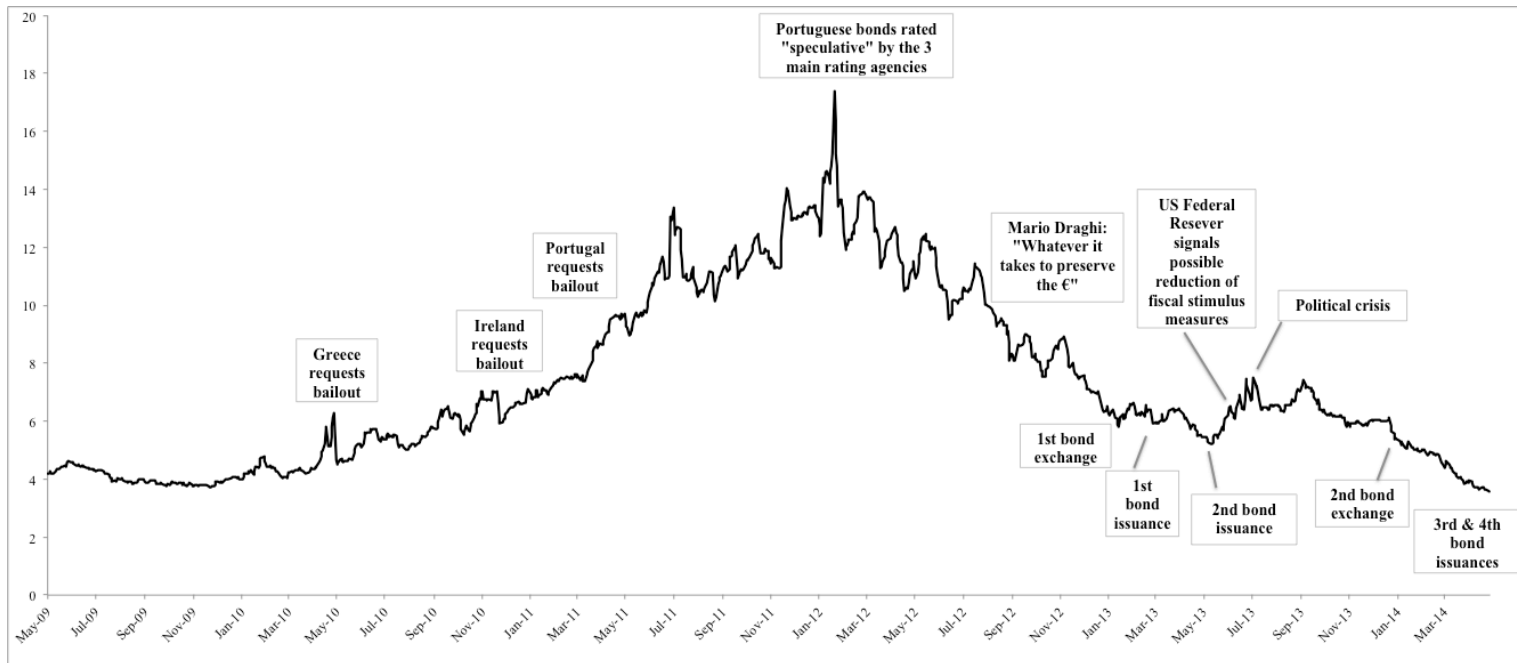
#### Exhibit 5: Portugal's public debt, 1991-2010 (% of GDP)

Source: PORDATA



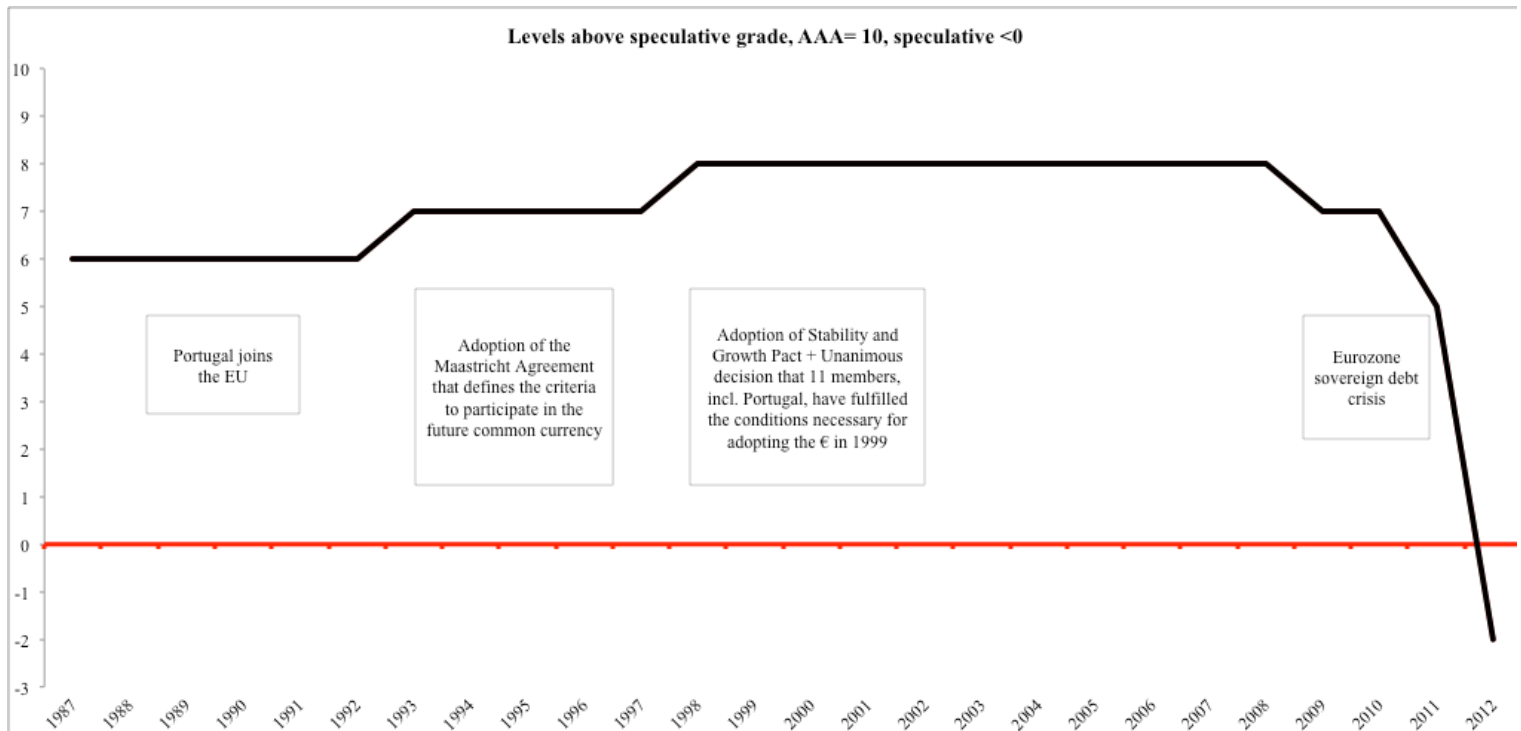
### Exhibit 6: Yields on 10-year Portuguese bonds, May 2009 to April 2014

Source: Bloomberg



### Exhibit 7: Average rating of the Portuguese Republic by the 3 main rating agencies, 1987-2012

Sources: IGCP and Bloomberg



**Exhibit 8: Selected slides of the debt management office's presentation to investors**

Source: IGCP



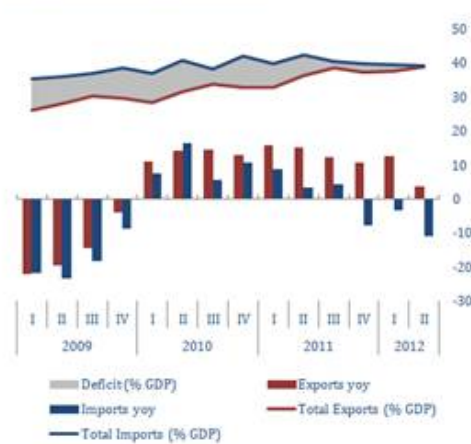
**PORTUGAL – Shifting the Economic Paradigm**

3) External Adjustment

**Balance of Goods and Services has reached the turning point on the back of a strong exports performance**

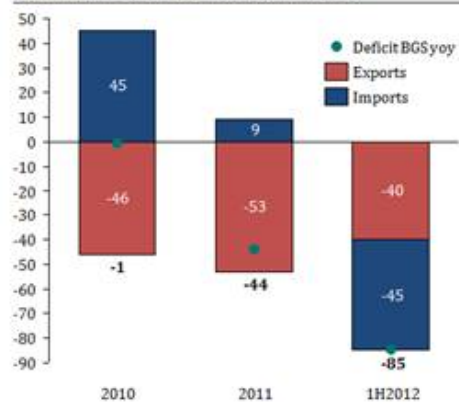
**Balance of Goods and Services has adjusted...**

[Balance of Goods and Services, %]



**... triggered by strong exports increase**

[Contributions to reduction of deficit in BGS, %]



Source: Banco de Portugal



Source: Banco de Portugal

**Exhibit 9: Anti-austerity Protests in Portugal, September 2012**

Source: Reuters<sup>20</sup>

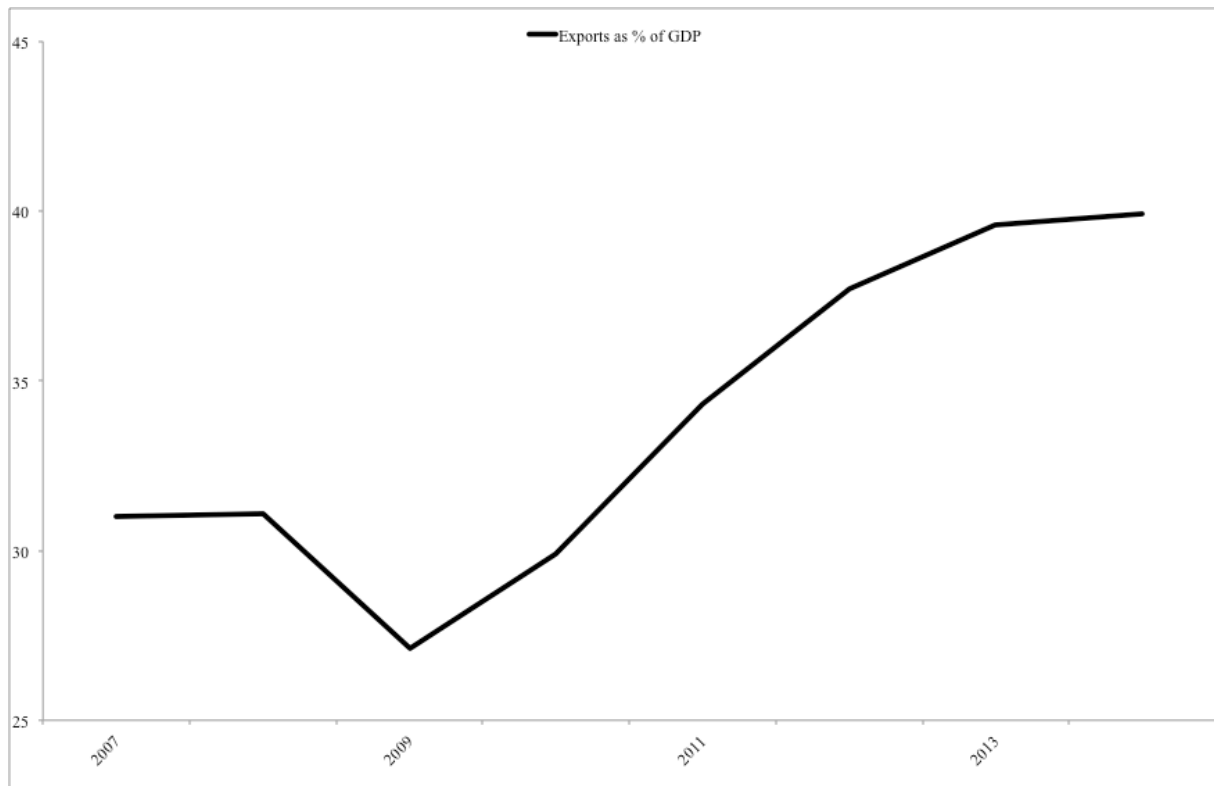


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<sup>20</sup> <http://www.reuters.com/article/2012/09/29/us-portugal-protest-idUSBRE88S0E520120929>

**Exhibit 10: Portugal's exports as % of GDP, 2007-2013**

Source: OECD



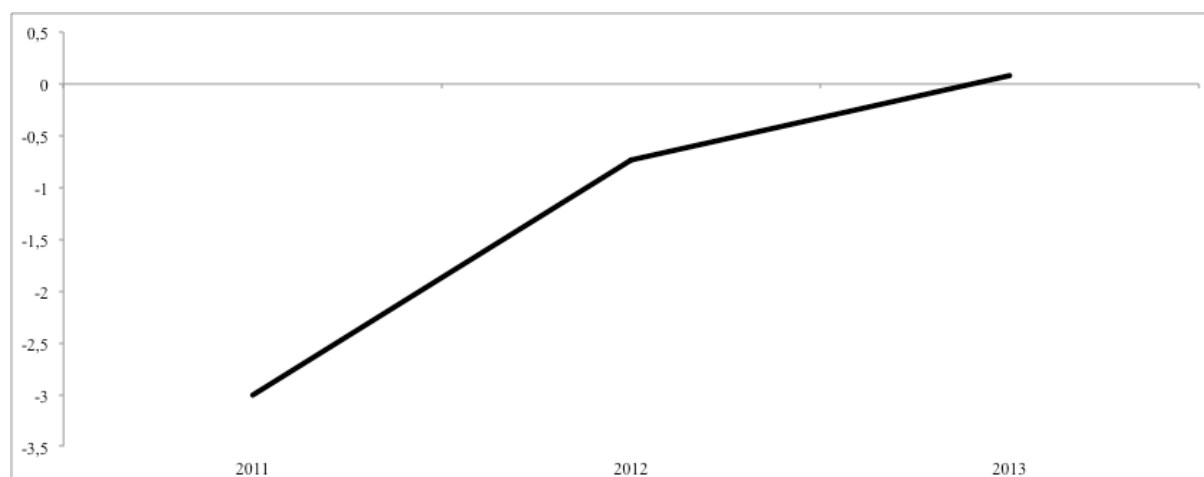
### Exhibit 11: Selected macro-economic indicators

Source: OECD, Eurostat, European Central Bank

	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1
GDP growth	-0,75	-0,46	-0,74	-1,55	-0,42	-1,42	-1,12	-1,61	-0,02	0,47	-0,12	1,03	-0,51
Unemployment	11,9	12,3	12,7	13,7	14,3	15,1	15,8	16,8	16,9	16,6	16	15,3	14,5
Current account (% of GDP)	-7,6	-9,1	-4,1	-3,2	-4,6	-2,1	-1,2	-0,3	0,3	2,2	0,4	2,7	-0,7
Government debt (% of GDP)	95,1	107	110,7	108,2	111,9	118	120,5	124,1	127,4	131,3	128,8	128,9	132,9

### Exhibit 12: The government's primary balance, 2011-2013

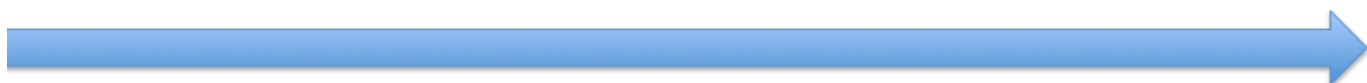
Source: European Central Bank



### Exhibit 13: Portugal's successive steps back to markets

Source: IGCP

	<b>October 2012</b>	<b>May 2013</b>	<b>January 2014</b>	<b>April 2014</b>
<i>Type of operation</i>	Bond exchange	Syndicated issue	Syndicated issue	Auction
<i>Maturity</i>	September 2013 for October 2015	10 years	5 years	10 years
<i>Volume</i>	€3.757 billion	€3 billion	€3.25 billion	€750 million
<i>Average yield</i>	5,12%	5.67%	4.66%	3,57%
<i>Demand</i>	€3.757 billion	€10.403 billion	€11.2 billion	€2.6 billion



	<b>January 2013</b>	<b>December 2013</b>	<b>February 2014</b>
<i>Type of operation</i>	Syndicated issue	Bond exchange	Syndicated issue
<i>Maturity</i>	5 years	2014 and 2015 for 2017 and 2018	10 years
<i>Volume</i>	€2.5 billion	€6.642 billion	€3 billion
<i>Average yield</i>	4.89%	4.68% and 4.96%	5.11%
<i>Demand</i>	€12.284 billion	€6.642 billion	€9.7 billion

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## TEACHING NOTE

### 1. *Pedagogical objectives of the case*

This case describes how Portugal, a country highly dependent on external sources of capital, found itself deprived of access to international borrowings during the Eurozone sovereign debt crisis, and how it gradually rebuilt access to markets between 2012 and 2014. Its objectives are threefold:

1) To examine how a country subject to an international financial adjustment programme rebuilt its credibility on financial markets through a deliberate set of strategic actions;

2) To map out the universe of sovereign bond investors and their respective motivations and constraints;

3) To describe some of the technical aspects of issuing sovereign debt (auctions/syndicates, exchanges, maturities).

The main take-aways that should result from the discussion in class are the following:

1) Portugal, a small, open economy that belongs to a currency union, is very exposed to fluctuations of market perceptions, even when the underlying causes of those oscillations are external. Conversely, solutions for a situation like that described in the main body of this document also lie, at least partially, outside of Portugal. In this specific case, the efforts and attitude of the Portuguese government were a necessary albeit insufficient condition to restore the country's access to financial markets. The support of Eurozone institutions, in particular, was key for markets to renew their confidence in Portugal as a credible sovereign issuer (just as Portugal's participation in the Euro had influenced the market's perception of the country's creditworthiness).

2) Trust is of the essence in sovereign debt markets, especially because enforcement of creditor rights against a sovereign debtor in case of default is very difficult to execute. This means that even just the suspicion that creditors may suffer losses is likely to result in capital fleeing elsewhere. It is therefore essential to maintain a sovereign issuer's credibility *vis-à-vis* capital markets and that involves communicating in a transparent and predictable way with key players.

3) Public debt can and should be actively managed to minimize risks of a disruption of the State's financing, which can have implications for the whole of the economy. That involves attracting the right talent; defining the right strategy; and consistently executing it. For example, just as an investor diversifies away risk by holding in its portfolio different types of securities, so should a sovereign issuer aim at developing and maintaining a diversified investor base to dilute the risk of finding itself deprived from access to capital markets.

## **2. Review of the relevant academic literature**

There is a large body of literature about fiscal policy, debt sustainability and the Eurozone sovereign debt crisis. However, there is little work published on sovereign debt management in general, and at times of hardship in particular. This paper aims to contribute to the body of knowledge on sovereign debt by illustrating some of the mechanisms of its management.

My primary sources were publications of the debt management office of Portugal (IGCP), of the European Central Bank (ECB), of the European Commission (EC) and of the International Monetary Fund (IMF). I also resorted to articles from economic media for context and reconstructing the chronology of events.

### **Theory of fiscal policy**

For the basics on the theory of fiscal policy, I referred to Rigobon (2013) and Mankiw (2009), who both present the theoretical models of fiscal policy, including fiscal sustainability. Rigobon in particular discusses the concept of "negative loop" of sovereign debt default cycle. Mankiw's focus is on government debt and budget deficits.

### **History of fiscal behaviours and sovereign debt crisis**

In *This Time Is Different: Eight Centuries of Financial Folly* (2011), C. M. Reinhart and K. Rogoff describe the cyclicity of sovereign defaults over time, and identify the main causes behind those events and their long-term repercussions.

The paper "Currency Crisis and Collapses" (1995) by R. Dornbusch, I. Goldfajn, and R. Valdés, examines four similar crisis of currency, and introduces many helpful insights on the behaviour of external lenders and the causes that can lead to a "sudden stop" of capital inflows.

"The Color of Hot Money," (2000), an article by M. N. Baily, D. Farrell, and S. Lund published *Foreign Affairs*, looks at financial crisis in emerging markets in the late 1990s and introduces important notions on capital volatility and behaviours of investors at times of turmoil.

### **Eurozone**

In "The size and composition of government debt in the euro area," D. Hartwig Lojsch, M. Rodríguez Vives, and M. Slavík examine the size and composition of government debt of the euro area as a whole, and of its members until 2010. This paper introduces many useful concepts on public debt, namely on liquidity aspects of debt, and explains how different debt compositions (in terms of creditors, maturities, types of instruments) can create more or less vulnerabilities to funding shocks.

## **Portugal**

The most relevant sources of information on the specifics of the Portuguese case are the debt management office's own publications. Reports from the IGCP from 2008 to 2013 are available online and provide a lot of information about strategic decisions and events that took place during those years, including statistical data. The articles "Building blocks" by Wright, P. (2015) and International "Sovereign risk manager of the year: IGCP" of Risk.net (2015), are also helpful in that they present a summary of the IGCP's strategy over the two years covered by this case. The interview of João Moreira Rato by *Diário Económico* (2014), available online, is also a fundamental source of information on the strategy of the debt management office.

P. Trigo Pereira (2012) investigates the historical evolution of Portuguese public debt and provides some theoretical background debt management. In "Portugal and the Global Financial Crisis—short-sighted politics, deteriorating public finances and the bailout imperative", P. Trigo Pereira and L. Wemans look in more detail at the factors that lead Portugal into requesting a bailout.

## **Other relevant aspects of public debt**

In "Loose lips sinking markets?" Gade, T., Salines, M., Glöckler, G. and Strodthoff, S. provide an analysis of the impact of political communication on sovereign bond spreads, and conclude that "unconstructive and inconsistent communication can have real and tangible effects on countries, [and] their financing conditions". They highlight the importance of having a carefully designed communication strategy that "minimizes the financial impact of political announcements on sovereign bond yields".

In "Rollover risk and credit risk", Z. He and W. Xiong examine the interaction between the liquidity premium and default premium, and highlight the role of short-term debt in exacerbating rollover risk.

In "Credit-Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response", L. J. White examines the role that the three largest credit-rating agencies played in the financial crisis of 2007-2008 and the subsequent sovereign debt crisis of the Eurozone.

In "Real Money Investors and Sovereign Bond Yields", L. Jaramillo and Y. Zhang examine factors that determine countries' borrowing costs beyond macro and fiscal fundamentals, namely the effect of "real money investors" on bond yields. Their work is based on a sample of 45 advanced and emerging market economies.

### 3. Road map for class discussion

#### Factual questions:

#### 1. What was the outcome of auction of April 2014?

Demand far exceeded the target amount: it surpassed €2.6 billion while the allocated amount was €750 million. The interest rate paid by the issuer was 3,57%, below secondary market yields. In the following days yields went up, meaning that the price of the bond came down.

#### 2. Did Portugal exit its bailout programme with or without resorting to the precautionary credit line of the European Stability Mechanism? How did markets react?

On May 4th, 2014, the Prime Minister announced in a televised address that Portugal would not resort to the Eurozone's precautionary line. This didn't have an impact on secondary market yields. Portugal effectively left its bailout programme on May 17, 2014. In the days that preceded the formal exit, yields on secondary markets increased from below 3.5% to almost 4%.

#### 3. Did Portugal raise money from markets in the rest of 2014? How?

Date	June 11th	July 2nd	Sept. 3rd	Oct. 8th	Nov. 12th	Nov. 26th	Nov. 26th
Operation	Auction	Syndicate	Syndicate	Auction	Auction	Exchange	Exchange
Maturity	10-year	10-year	15-year	5 year	10 year	2015 & 2016 for 2021	2016 & 2015 for 2023
Volume	€975 million	\$4,5 billion	€3,5 billion	€1,804 billion	€1,2 billion	€943 million	€805 million
Av. yield	3,252%	3,65%	3,875%	1,856%	3,177%	2,163%	2,838%

#### 4. What can be concluded from the information above?

Portugal managed to conduct several auctions at reasonable prices following its exit from the programme, meaning its access to external funding was normalized.

### Challenge questions:

**5. Why wouldn't João Moreira Rato and his team offer clear and definite answers to their interlocutors when these asked difficult questions on social unrest, or political stability?**

It was too much of a risk and contrary to their objectives. Had things evolved in ways different from what they expected, their credibility would have been completely compromised. Their goal was to re-establish confidence in Portugal as a credible, competent, trustworthy sovereign issuer; that required being realistic about risks, and presenting facts, not opinions.

**6. How is sovereign bankruptcy different from corporate bankruptcy? What does that imply?**

*"In corporate or individual bankruptcy, creditors have well-defined rights that typically allow them to take over many of the debtor's assets and put a lien on a share of its future income. In sovereign bankruptcy, creditors may be able to the same on paper, but in practice their enforcement power is very limited."*<sup>21</sup>

The implication is that trust is at the heart of sovereign lending, even more than so than in private lending.

**7. How did troika statements influence the course of events?**

The troika played the role of an external, independent auditor to Portugal's economic and financial policies and statistics. Its statements were therefore highly scrutinized by the international community.

**8. How do international media influence events?**

The way international media report domestic events shapes the way non-local investors perceive them. The issuer should therefore take care to be as transparent as possible to ensure that information abounds. It should also be vigilant and address issues caused by inaccurate or erroneous reports.

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<sup>21</sup> *This Time Is Different: Eight Centuries of Financial Folly* (2011), C. M. Reinhart and K. Rogoff

**Possible assignment questions:**

- Look into annual reports of European insurance companies between 2007 and 2014 and analyse their investment in sovereign debt. What are the top 3 countries in which have they invested? What is the rating of those countries? Has exposure to those countries evolved? How?
- What is your opinion on the role credit rating agencies played in the Eurozone sovereign debt crisis?
- "Rollover risk & credit risk are two sides of the same coin". Explain.
- Would events have taken a different course had the Portuguese government adopted an ambiguous position towards its ability or desire to honour its debts? Or was the government's attitude secondary to the support given by Eurozone authorities and the influence of external events?