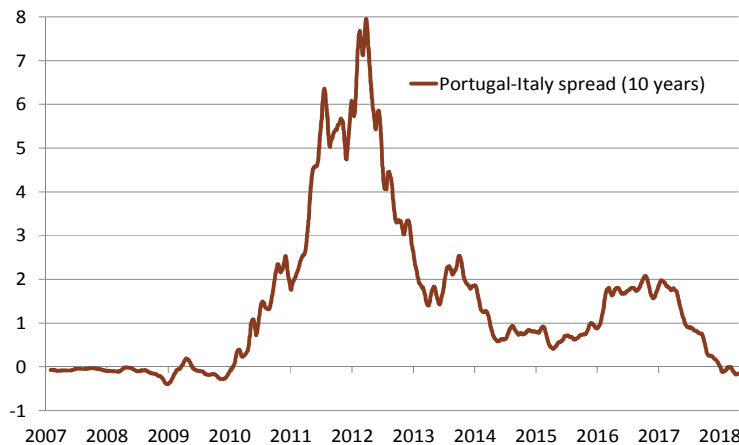




20 April 2018

Southern Europe: reforms pay off

The sweet taste of success: Portuguese yields have fallen below Italian yields



One-month moving average. Source: Bloomberg. Data shows difference between Portuguese and Italian 10-year government bond yields in percentage points.

- Time heals many wounds:** Reforms can set struggling countries on the right track. The recent ratings upgrades for Spain and Portugal exemplify the progress that most countries on the southern European periphery have made since the euro confidence crisis some six years ago.
- Portugal on the right track:** Portugal has long been our bond market favourite in southern Europe. Although still less dynamic and saddled with a higher debt burden than Spain, it has turned itself into an attractive place for inward investment again. Most importantly, it has come through the 2015 change in government with flying colours. Despite some small-scale reform reversals, the leftist government is pursuing a sound fiscal policy. Prime Minister António Costa has tamed two small leftist groups with euro-sceptic tendencies. They have supported his staunchly pro-European government without a major hiccup. The economic and political outlook seems stable.
- Spain has made huge progress:** Courtesy of earlier reforms and rapid economic growth, unemployment has fallen from a horrific peak of 26.3% in 2013 to 16.1% now, and looks set to decline much further. Over time, this should help to address the remaining fiscal problems. The Catalonia issue has degenerated into a farce rather than a serious threat to Spain's economic outlook. On the political scene, the pro-business Ciudadanos has taken over from left-wing Podemos as the group with momentum on its side. Euro-scepticism has not taken roots in Spain.
- Greece continues to struggle:** Although the economy has started to grow again, the pace remains more tepid than it should be. Under the supervision of creditors, Greece has introduced serious reforms and fixed its budget. But after then-finance minister Yanis Varoufakis shattered investor confidence in his futile confrontation with creditors in early 2015, investors are returning only hesitantly. Fortunately, the political situation looks promising. Having already had almost the worst possible government in 2015, chances are that either a chastened Alexis Tsipras will stay on as Prime Minister after the elections in 2019 or – more likely – be replaced by the solidly pro-reform conservative opposition.
- Italy has turned into our top concern in Europe:** The risk of euro exit looks very low as even the radical parties are turning away from an idea that could drastically destabilise the country. But as the reform drive of the years 2011-2017 has petered out prematurely, Italy remains a half-reformed place struggling with serious political uncertainty. The risk that a new government dominated by radical parties could reverse some reforms and abandon fiscal prudence looms large. In an economic recovery, this may not matter much. But some time in the future, perhaps after a potential global downturn in, say, 2021, Italy may find itself vulnerable to a new crisis if it strays too much from the sensible path now. We continue to prefer Portuguese over Italian bonds.

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