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Ireland, Portugal Stir European Fears

Anglo Irish Bank's Credit Rating Is Cut While Political Disputes in Lisbon Threaten Austerity Plans

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By BRIAN BLACKSTONE

FRANKFURT—Concerns over the financial stability of countries on the euro-zone's fringe mounted Monday as one of Ireland's largest banks had its credit rating cut and political tensions fueled doubts about Portugal's deficit-cutting plans.

Moody's Investors Service downgraded the senior debt of Anglo Irish Bank Corp. by three notches to Baa3. Ireland's property-market collapse has crippled its banks, and the government has so far spent €33 billion ($44.5 billion), about one-fifth of its gross domestic product, rescuing them.

Bloomberg News
Moody's Investors Service downgraded the senior debt of Anglo Irish Bank. Above, the bank's headquarters in Dublin.

Separately, Portugal's finance minister insisted the indebted country's government would press ahead with plans to cut its budget deficit, despite threats by opposition lawmakers to block further tax increases. Uncertainty about Portugal's ability to take extra fiscal steps is pushing up yields on the country's debt, a sign of rising investor concern.

Recent developments in Ireland and Portugal have rekindled fears of financial turmoil on the euro-zone periphery that could potentially threaten Europe's banking sector and even the global economic recovery.

Coming days could be a crucial test of whether European governments can prevent the return of a crisis of confidence that rocked the region this spring. Ireland is expected to say this week how much the rescue of Anglo Irish will cost, while Portugal's president and party representatives are expected to hold talks on Tuesday and Wednesday in a bid to end a budget stalemate.

Analysts are also eyeing proposed legislation due Wednesday from the European Commission to strengthen sanctions against countries that break EU budget rules.

Financial markets are on edge as crisis-hit euro-zone countries try to pull off a daunting task: protect their banks while slashing budget deficits against a backdrop of economic stagnation and soaring joblessness.

Some economists say it can't be done and see it as increasingly likely that one or more of these countries will eventually have to tap a massive rescue fund set by the European Union

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and International Monetary Fund, stirring fresh uncertainty about the 16-nation currency bloc.

The euro retreated from five-month highs against the dollar Monday thanks to the banking and deficit concerns.

But data released Monday suggested that the region's recovery as a whole remains intact. Bank lending increased, as did money supply in the euro zone, an indication that the European Central Bank's massive lending programs initiated at the height of the financial crisis are leading to more lending by commercial banks, which should fuel business and household spending.

The currency zone's overall recovery masks deep divisions within the region. Ireland's GDP plunged nearly 5%, at an annualized rate, during the second quarter, raising doubts about whether Dublin can generate enough tax revenue to trim its budget deficit.

ECB President Jean-Claude Trichet has repeatedly praised Dublin's efforts to repair its state finances, and ECB officials have hailed its spending cuts as a model for other high-debt countries such as Greece.

In an EU Parliament hearing on Monday, Germany's Sven Giegold challenged Mr. Trichet, noting that Ireland's "good pupil" behavior hasn't stopped it from becoming "the first country to see a double-dip" downturn, and asking Mr. Trichet "what lessons to draw." Mr. Trichet replied that Ireland "has proved in the past that they were able to take up the difficult challenges they had to face up to."

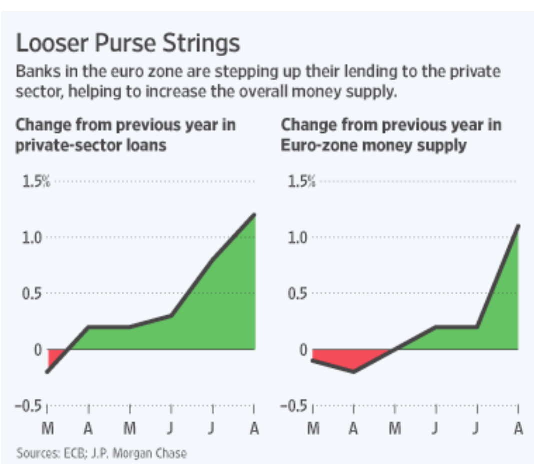
"If the policy path is broadly right...and the market continues to charge you a funding cost that is clearly unsustainable, why not use the facilities available?" Goldman Sachs economist Erik Nielsen said in a note to clients. Ireland has to pay over 4.5 percentage points more than Germany to borrow at 10-year maturities.

Greece is already operating under a separate EU-IMF bailout package that largely covers its funding needs into 2012. But even that rescue has failed to quell doubts in financial markets about Athens' ability to repay its debts further down the road.

Yields on 10-year Greek government bonds are above 11%, and on Monday Standard & Poor's global head of sovereign ratings, David Beers, said a restructuring of Greek debt is "one of the options that we have to consider."

To avoid future debt crises such as Greece's,Mr. Trichet called on Monday for beefed-up surveillance of European budgets, including an advisory panel of "wise men and women at the EU level who would provide a second opinion."

Financial markets have also set their sights on Portugal. The yield spread between Portuguese and German 10-year bonds rose to 4.2 percentage points Monday, showing that investors are questioning Lisbon's ability to rein in its budget deficit even as Portugal's finance minister, Fernando Teixeira dos Santos, called deficit reduction an "immediate priority of the Portuguese government."



Organization for Economic Cooperation and Development Secretary-General Angel Gurria, offered Lisbon verbal support. "I am confident Portugal will weather this crisis," he said at a news conference presenting the OECD's latest economic report on Portugal.

Portugal's government, lacking an overall majority in parliament, needs some opposition support to push through its policies. The opposition Social Democratic Party said last week said it won't approve the government's budget if it includes fresh tax increases. Portuguese Prime Minister Jose Socrates Friday warned that if the budget were not to be approved, the government wouldn't be able to function.

Ireland, Portugal and Greece together make up only about 6% of euro-zone GDP, but Greece's near meltdown this spring showed the potential of even small economies to trigger wider financial panic. Of the three, only Portugal's economy expanded last quarter, albeit at only a 1% annualized rate.Much of the rest of the currency bloc appears on solid footing.The region grew at nearly a 4% rate last quarter, though most economists expect a significant weakening this quarter and next.

Despite the growing worries the three countries, the ECB last week scaled back its purchases of government bonds to EUR134 million, the lowest in six weeks. Under the program, which began May 10, the ECB has bought EUR61.5 billion worth of the debt of Greece and other at-risk countries. The central bank doesn't disclose country details.

The region is expected to skirt a renewed contraction, ECB officials say, a forecast supported by the bank's latest money-supply and lending figures. The ECB's broadest measure of money supply increased 1.1% from a year ago, a much bigger rise than economists had expected. Private-sector lending rose 1.2%, thanks to a 2.9% rise in lending to households that offset a slight drop in business loans.

"Things are going in the direction of a little more dynamism," Mr. Trichet told EU parliamentarians, referring to Monday's credit figures.

—Irene Chapple and Bernd Radowitz contributed to this article.

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