

## ISSUER COMMENT

# Portugal: Constitutional Court Decisions Complicate Fiscal Consolidation Path

---

**Table of Contents:**

SUMMARY	1
2014 BUDGET DEFICIT TARGET REMAINS ACHIEVABLE DESPITE COURT RULINGS...	2
.. BUT TARGETS FOR 2015 AND BEYOND HAVE BECOME MORE UNCERTAIN	3

---

**Analyst Contacts:**


---

**LONDON** +44.20.7772.5454

Kathrin Muehlbronner +44.20.7772.1383  
*Vice President - Senior Credit Officer*  
 kathrin.muehlbronner@moodys.com

Yves Lemay +44.20.7772.5512  
*Managing Director - Banking*  
 yves.lemay@moodys.com

---

**NEW YORK** +1.212.553.1653

Bart Oosterveld +1.212.553.7914  
*Managing Director - Sovereign Risk*  
 bart.oosterveld@moodys.com

---

**FRANKFURT** +49.69.70730.700

Dietmar Hornung +49.69.70730.790  
*Associate Managing Director*  
 dietmar.hornung@moodys.com

---



---

**Summary**

*Portugal's 2014 fiscal target still on track, but court's rulings raise question marks about expenditure-focused consolidation strategy thereafter*

On 30 May, the Portuguese Constitutional Court deemed unconstitutional three fiscal measures contained within the government's 2014 budget worth an estimated €500 million (0.3% of 2014 estimated GDP).<sup>1</sup>

The Court's decisions are not unexpected as it was not the first time that the country's Supreme Court rejected budgetary measures<sup>2</sup>. The government indicated that it might have to resort to tax increases, but will await the Constitutional Court's rulings on two further budgetary measures before it announces alternative initiatives.

Despite the decision, we believe this year's fiscal target of 4% of GDP for the general government – which was agreed with Portugal's international lenders – to remain achievable. Our view is driven by (1) the limited fiscal impact of the rejected measures in 2014; (2) the better than expected starting point for this year's budget, given that last year's budget deficit outperformed targets by around 1% of GDP<sup>3</sup>; (3) the fact that economy is expected to outperform growth forecasts at the time of the budget formulation in October 2013; and (4) the government's strong commitment to fiscal consolidation.

At the same time, the court's decisions clearly complicate the fiscal consolidation task. Given the high level of expenditure and the steep tax increases already implemented in the past few years, we believe that it will be difficult to materially and consistently reduce the budget deficit in the coming years if the government is unable to address its key spending areas. Our Ba2 government bond rating for Portugal is currently on review for upgrade, pending the government's response to the court's ruling and our assessment of the country's medium-term fiscal prospects.

<sup>1</sup> The measures rejected by the constitutional court are (i) cuts to public sector salaries of more than €675 a month; (ii) changes in the way widows' and widowers' pensions are calculated; and (iii) levies on sickness pay and unemployment benefit. A fourth measure, relating to pension complements at specific state-owned enterprises (budgetary impact of €6 million) was upheld.

<sup>2</sup> The recent Constitutional Court decision is the fifth adverse ruling on fiscal measures since mid-2012.

<sup>3</sup> See Issuer Comment [Portugal Comfortably Meets 2013 Budget Deficit Target, a Credit Positive](#)

## 2014 budget deficit target remains achievable despite court rulings...

We believe that despite the negative rulings the 2014 budget deficit target of 4% of GDP (2013: 4.9% of GDP) should be achievable. Firstly, the rejected measures will not be reinstated for the past months but only apply for the remainder of the year. The Portuguese authorities estimate the overall impact of the rejected measures on the 2014 budget performance at close to €500 million (0.3% of 2014 estimated GDP), compared to their full-year impact in the 2014 budget of €800 million. Secondly, the starting point for this year's budget has improved significantly following the outperformance last year, when the general government deficit was €1.7 billion (1% of GDP) lower than targeted.

Thirdly, the economy is performing more strongly than expected in the 2014 budget; i.e., the budget was based on real GDP growth of 0.8%, while our current forecast assumes a growth rate of 1%. Indeed, the budget execution for the first four months of the year points to a reasonably strong revenue performance (+4.4% year-on-year compared to assumption of +1.7% underlying the budget). Spending has also been kept under tight control over the same period (+0.8% compared to last year).

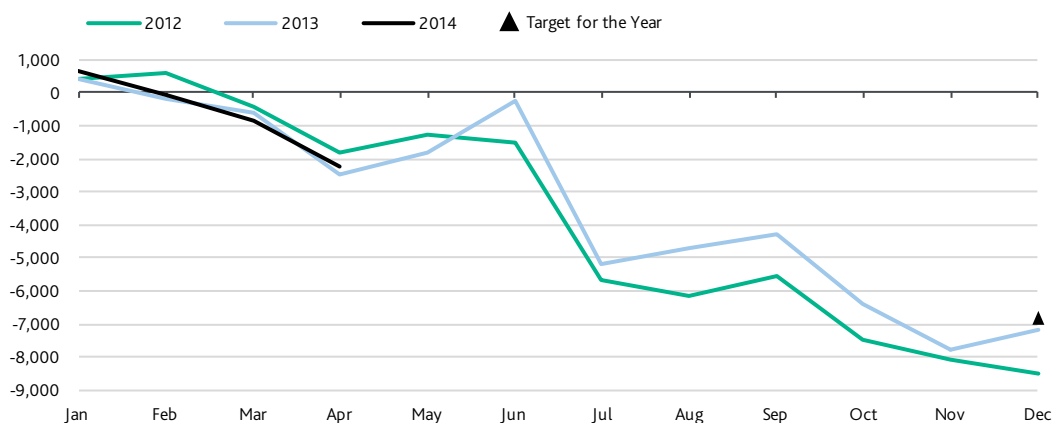
Lastly, as in past rulings, the court's main objection relates to the "proportionality" and "fairness" of the measures, meaning the government could to introduce alternative measures or tone down and amend those that had previously been rejected. We consider the commitment of the government to fiscal consolidation to be very strong.

The Constitutional Court is expected to rule on two further measures contained within the 2014 budget, the combined full-year impact of which are estimated at €200 million. The timing of these decisions is unclear, and the government indicated that it would wait for these rulings before presenting alternative measures. The government has also asked the court for clarification on the boundaries of accepted measures, although it is unclear whether it will do so.

### EXHIBIT

#### Budget Execution On Track So Far In 2014

(€ Million, cumulative)



Source: Ministry of Finance, Moody's

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moodys.com](http://www.moodys.com) for the most updated credit rating action information and rating history.

## .. but targets for 2015 and beyond have become more uncertain

According to the government's recently published medium-term fiscal strategy, achieving its 2015 deficit target (2.5% of GDP) will require additional fiscal measures of around 0.8% of GDP (€1.4 billion), assuming full implementation of the 2014 measures. Following the court's decision, the government indicated that it might have to resort to tax increases to compensate for the impact of the rulings. While this underlines the government's commitment to reducing the fiscal deficit further, further tax rises also carry risks for the still fragile economic recovery.

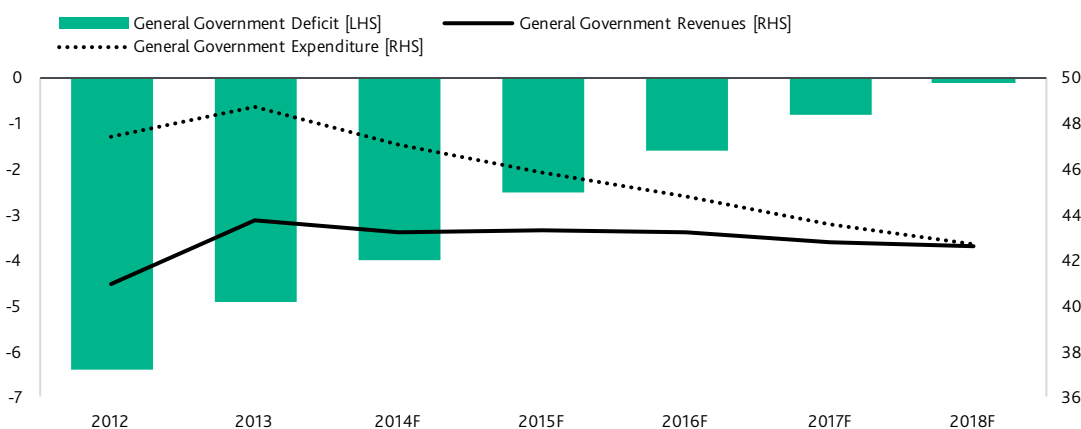
Over the longer term, the court's decisions raise question marks over whether the planned fiscal consolidation path – achieving a balanced budget by 2018 – can be achieved if important spending categories cannot be reduced. Given the elevated levels of expenditure – at around 49% of GDP in 2013 – and the significant tax increases implemented in 2013, the government has shifted the focus towards adjusting the size of the public sector and its overall spending levels. The public-sector wage bill and pensions are among the largest expenditure items, accounting for around 60% of total general government spending and 67% of government revenues (as of 2013). The court rulings render such an expenditure-focused fiscal consolidation strategy more difficult.

At the same time, we acknowledge that the court's objections mainly relate to the 'proportionality' and 'fairness' of the measures. This leaves the door open for the government to come up with alternative measures or amend those that have been rejected, which the government has done in similar circumstances in the past.

EXHIBIT 2

### Consolidation Efforts To Rely Mostly on Expenditure-Side Measures

% of GDP



Source: Haver-Eurostat, Ministry of Finance, Moody's

Report Number: 171713

**Author**  
Kathrin Muehlbronner

**Editor**  
Matthew Bridle

**Production Specialist**  
Wendy Kroeker

© 2014 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

**CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. ("MIS") AND ITS AFFILIATES ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.**

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS FOR RETAIL INVESTORS TO CONSIDER MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS IN MAKING ANY INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

MIS, a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at [www.moody.com](http://www.moody.com) under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

For Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be dangerous for "retail clients" to make any investment decision based on MOODY'S credit rating. If in doubt you should contact your financial or other professional adviser.