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Portugal: The Politics of Austerity

Darren Williams
Senior European Economist—Global Economic Research

As the fiscal adjustment enters its next phase, politics will remain a key risk in Portugal. Public opposition to austerity and challenges from the Constitutional Court pose barriers to reforms as the country seeks to regain market access.

Politics have been a central risk to the fiscal adjustment in Portugal, a country at the heart of the euro-area sovereign-debt crisis. This year, Portugal's economy has shown some signs of life—the economy has started to grow, unemployment has fallen and there has been a significant improvement in the current account position. But international attention has stayed focused on risks posed by political divisions in the national debate on austerity.

Public opinion has rejected budget cuts and fueled dissent in parliament, leading to the resignation of several ministers this summer. In addition, the Constitutional Court has added another layer of uncertainty, voting down important legislation and raising doubts over the country's capacity and tolerance for additional fiscal and structural reform.

As Portugal prepares to end the current bailout facility in mid-2014 and hopes to reenter capital markets, political barriers to the country's rehabilitation will be critical. While the government does not want a second bailout loan, we believe there are risks that it will not be able to return to market-based financing within such a short time window.

Signs of Economic Recovery

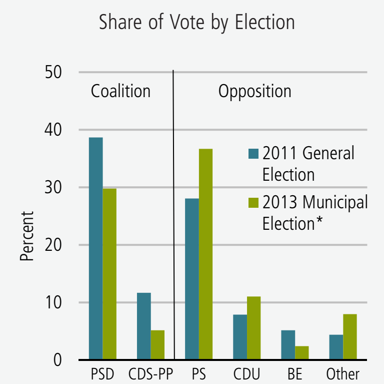
After 10 consecutive quarters of decline, real gross domestic product (GDP) rose by an impressive 1.1% in the second quarter, supported by a stabilization in domestic demand, net exports and a temporary boost from inventories. Since June, economic sentiment and coincident activity indicators have improved further and are consistent with positive growth in the third quarter—though the pace is likely to slow from the second quarter as temporary factors wear off.

With the recovery in economic conditions, there has been a reversal in the unemployment rate, which has dropped from a peak of 17.6% in February to 16.5% by August.

The Politics of Austerity

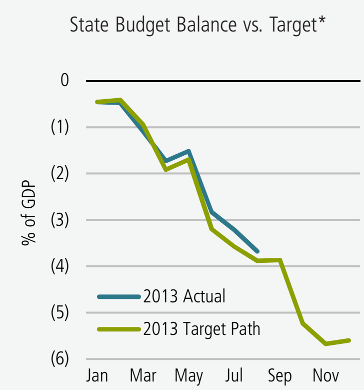
But years of fiscal adjustment and recession have come at a heavy cost. Although Portugal's adjustment program has received praise from international

Display 1
Ruling Coalition Loses Support



*Adjusted to take into account votes for candidates that ran in coalition
Main parties: Social Democratic (PSD); People's Party (CDS-PP); Socialist (PS); Communist/Greens (CDU), Left Bloc (BE)
Source: CNE (election commission), Autárquicas 2013 and AllianceBernstein

Display 2
Fiscal Performance In Line



*To meet 2013 state deficit target of 5.6% of GDP
As of August 31, 2013
Source: DGO (budget directorate) and AllianceBernstein

lenders, it has won few domestic supporters. As a result, the center-right coalition government—between the Social Democratic Party (PSD), led by Prime Minister Pedro Passos Coelho, and the People's Party (CDS-PP)—has faced the same public backlash that led to the early demise of the previous Socialist Party administration. In municipal elections on September 29, support for the PSD and CDS-PP fell to 35% **(Display 1, previous page)**, down from 50% at the 2011 general election. Voters punished the coalition for its adherence to tax hikes and spending cuts, while the Socialist Party—formerly the chief target for austerity angst—was the big winner, gaining the largest number of municipal chambers in its history.

The unpopularity of the fiscal adjustment has come at a tough time. Without market access, and with a visit from the European Union (EU) and International Monetary Fund (IMF) always just around the corner, Portugal's options are severely limited.

Back in July, the government risked collapse over internal disputes which started with the resignation of finance minister Vitor Gaspar—the architect of the austerity plan—who cited a lack of public support. While the crisis has been papered over for now, dissent has continued. Mounting pressure from public opinion, opposition parties and the junior coalition partners to ease austerity has put the PSD in a difficult place and forced requests to renegotiate the terms of the bailout.

Constitutional Court Challenges

Aside from political opposition, the reform plan has also faced concerted legal challenges. Portugal's Constitutional Court has played a central role in the public debate, voting down important government reforms in violation of the constitution on four occasions in just over a year. In April, the court rejected fiscal measures worth 0.8% of GDP, ruling that they discriminated against civil servants. In August, the court's decision cancelled a plan to phase out certain public sector workers, citing violations in the guarantee of secure employment. Although the cost of this decision will be limited in 2013 (less than 0.1% of GDP), the effect is expected to be more important in 2013 and 2014 (0.3% of GDP in each). And most recently in September, the court rejected several labor market reforms that were adopted in 2012. While many Portuguese feel the court has defended the country's welfare system, these decisions have also presented obstacles to the adjustment program.

Challenges from the Constitutional Court are unlikely to end soon. Opposition parties and labor unions have already planned to appeal the lawfulness of other unpopular measures to the court. This includes the increase in civil servants' working hours to 40 hours a week from 35 and a cut in public sector pensions.

Fiscal Performance Is on Track

In light of these setbacks, the performance of the fiscal balance so far this year has been encouraging. In March, Portugal's deficit target for 2013 was revised to 5.5% of GDP from 4.5%. Relative to the new target, Portugal's state budget up to August has performed in line **(Display 2, previous page).**

Earlier this month, the latest EU/IMF review noted that Portugal's program remained broadly on track. However, market attention focused on the rejection by lenders of Portugal's proposal to relax its fiscal targets in 2014 to 4.5% from 4.0%, proposed in response to domestic pressure to renegotiate the terms of the agreement.

As a result of this rejection, planned expenditure cuts of €4 billion (2.4% of GDP) will move ahead next year. The 2014 draft budget scheduled for October 15 is expected to continue down the path of reductions in the public sector wage bill, pension reform and a consolidation of ministry expenditures. But given significant objections to this approach over the past two years, the proposed actions are likely to meet dissent in parliament, and may also face fresh constitutional challenges.

Looking Forward to Next Year

Looking ahead, the government will need to continue balancing the forces of externally imposed fiscal discipline and internal social and political dissent. This balance has been tough to maintain in weak economic times. To this effect, the early recovery and improvements in the labor market have been especially welcomed by policymakers.

Next year, attention will quickly shift to the country's financing plan after the bailout facility ends in June. Portugal has made clear that it does not intend to seek a second bailout. New finance minister Maria Albuquerque has stated that the government plans to issue bonds in the market by early 2014 (following a successful issue early this year), and has rejected talk of another bailout loan.

However, we believe that the government may not be able to return to market-based financing so quickly. Moreover, if it is forced to enter a second program, additional political tensions could result, with new calls for an early election. Political uncertainty recently resulted in S&P putting Portugal on negative watch.

One option, we believe, is for Portugal to move from its EU/IMF bailout to a transitional Primary Market Support Facility with the European Stability Mechanism (ESM). This would allow the ESM to buy bonds in the primary market and ease the country's return to the financial markets.

Any decision on financing post-June will not be easy, and will face political resistance—especially with the next general elections due in 2015. As such, while the economy stabilizes and the fiscal adjustment enters its next phase, politics will remain a key factor—and may play a decisive role in market sentiment. ■

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