# Portugal's Strategy for Open Economy

**Jorge Braga de Macedo**
Nova School of Business and Economics

* Prepared for a parliamentary hearing on June 19, 2012, updating and revising presentations at *Faculdade de Economia do Porto*, *Associação Comercial de Lisboa*, €50Group meeting in Dublin and Bank of Finland.

# Two hundred years of ambiguity

- Until the Peninsular wars, complementary European and Atlantic allegiances preserved **financial reputation** (one bankrupcy vs seven in Spain).
- The subsequent clash between political and financial freedom survived several redistributive revolutions thanks to an **opaque fiscal constitution**: the 1975 nationalizations were not reversed until the two major parties agreed on a constitutional amendment – more than 2 centuries after the *14 Juillet 1789* (Bastille day).
- In comparison to the negative Greek view of European integration and the positive Irish or Spanish perspectives, an **ambiguous response** was the distinguishing Portuguese feature - until one year ago.

# Time - & issue- interdependence of reforms

- Reforms have different time frames depending on the institutions which need to be changed. In addition, fiscal and monetary policies, macroeconomic and structural policies are closely interrelated.
- Ambiguity generates **fragmented (piecemeal) reform implementation** and policy reversals: in Portugal, the gradual regime change towards **currency convertibility** began in 1989 but budgetary control remained fragmented after the *escudo* was last realigned in 1995.
- Excessive **primary government expenditure** and **state-led wage inflation** led to reform procrastination and the reversion of a purely demand-led boom: the initial "euro hold up" interrupted convergence of incomes towards the European average.
- During the "lost decade", productivity fell (table) and the current account deficit remained at 10% of GDP!

# Labour Productivity level and actual rate of growth in South EZ (4% expected by reference to North EZ and East EU)

| | level 2002 | % 02-08 |
|---|---|---|
| **Italy** | **49=1.00** | **-0,6** |
| **Spain** | **45=.92** | **-0,5** |
| **Greece** | **35=.71** | **-2,0** |
| **Port** | **26=.53** | **-0,1** |

Source: World Bank report **Golden Growth: Restoring the Lustre of the European Economic Model**, presented 27 April at Gulbenkian conference

# Euro did not change fiscal constitution

- Broad-based and sustained reforms did not begin until well after the world financial crisis and the request for external assistance: as reforms stalled or went into reverse, Portugal became a victim of the "euro hold up" and breached the Stability Pact.
- This was accompanied by a decline in aggregate savings and a shift in the composition of expenditure towards tradables, hurting export competitiveness in manufactures and services and discouraging **outward and inward** foreign investment.
- Aggregate labour productivity in 2002 was ½ of Italy and industrial productivity in the 1990s 1/3 of rich countries (=1).

# Export potential in manufacturing

- Other estimates in Causa and Cohen (2006) are Spain = .7; Greece = .5; Turkey = .4. Internationally traded investment goods are most relevant to aggregate productivity in the future.
- Total factor productivity in manufacturing during the 1990s is estimated as the product of physical capital per worker, human capital per worker, infrastructure (Z, measured by electricity generating capacity per worker), integration with the international trading system (T) and residual.
- The attractiveness of Portugal as a platform for industrial production measured by ZT is then 9/10 of rich countries< Spain=1 but> Greece= .8; Turkey=.5.

# From Blanchard to Gaspar

- Olivier Blanchard who consulted with Banco de Portugal before becoming chief economist at the IMF broke a taboo that lasted since 1983: at a conference in February 2006 (moderated by Victor Gaspar) he suggested a cut in nominal wages based on diagnostics that made in *persona non grata:*
  - *Productivity growth is anemic.*
  - *Growth is very low.*
  - *The budget deficit is large.*
  - *The current account deficit is very large.*
- Gaspar is now Minister of Finance: external deficit improved by 4 pp from 2010 to 2011, exports report double digit growth, wages fall is led by the public sector but **unemployment is very large**.
- Will the structural reforms carried out over the last 12 months (list) open the economy on time?

# List of structural reforms

- Labor market and Housing rentals package
- Corporate bankruptcy
- Competition law
- Reinforcement of supervisory powers of *Banco de Portugal*
- Creation of Fiscal Council
- Transparent and Profitable Privatization: EDP, REN
- Evaluation of Public-Private Partnerships
- Judicial map
- Restructuring of state owned enterprises
- Recruitment and selection in public administration
- Framework for public institutes

# Recovering competitiveness

- Expectations of convergence were disappointed by expenditure voracity and procyclical budgetary policy.
- Comparisons in EZ pit Germany against "peripherals" due to asymmetry of current account adjustment:
  - Credit rating downgrades since 1979 show Portugal close to Spain and Ireland to Greece
  - Portugal stands out in terms of improvement before the 2008 world crisis.
- **The economy remains closed for its size.**
- Migrant communities ½ of residents cannot be ignored in branding Portugal: without a greater appeal to "metanational" people (Santos, 2011) constituencies for open economy (beyond EU) will not be strong enough.

# Internationalization and Development

- Following the report of the Prime Minister's Working Party on Internationalization and Development the **Strategic Council for Open Economy** (CEIE) was formed in October 2011.
- Chaired by the Prime Minister it includes four Ministers of Finance, Foreign Affairs, Economy and Agriculture, together with the Presidents of six business organizations (CIP,CTP, CCP, CAP, AEP, AIP).
- During the adjustment period, CEIE meets quarterly to evaluate public policies and private initiatives, and their articulation aiming at the internationalization of the Portuguese economy and the promotion and attraction of foreign investment.

# Strategic Council for Open Economy

- The Agency for Portuguese Foreign Trade and Investment (AICEP) serves as secretariat to CEIE, and the work is prepared and monitored by a group of eleven alternates.
- At the 13 June meeting of CEIE, four reports were presented on how to
  - (i) improve financing of the economy,
  - (ii) simplify administrative procedures
  - (iii) simplify tax administration
  - (iv) develop a coordinated and effective external economic policy.
- The reports and their 55 recommendations will soon be available in the Government site, with execution dates for those the 44 that were approved.
- Before the next troika review, CEIE alternates should help evaluate structural reforms.

# Banking threat to EU internal market

- André Sapir warns that the crisis made the Anglo saxon social model **unsustainable**: from 2004 to 2010 public debt/GDP rose 42 to 81 whereas Continental rose from 75 to 90 and Mediterranean from 83 to 95).
- Downgrades since 2008 follow sequence of bailouts (Greece, Ireland, Portugal) but banking risk is now EZ wide.
- It will threat the EU internal market, unless:
  - The process towards banking union remains undefined;
  - The rallying cry *ni austérité ni croissance* spreads.