'STRUCTURAL CHANGE, COMPETITIVENESS AND INDUSTRIAL POLICY PAINFUL LESSONS FROM THE EUROPEAN PERIPHERY'

PART I – THE CONTEXT: EMU, CONVERGENCE, AUSTERITY

CHAPTER 3

Convergence and Imbalances in the EMU - the case of Portugal

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1 - Introduction

The subprime crisis started in the summer of 2007 was the trigger of a deeper financial and economic crisis, still unresolved. The intervention of public authorities to stabilize and rescue the financial system and to smooth the contractionary effects of the financial crisis deteriorated the fiscal position of governments in Europe and in other continents. The increase in public deficits and debts had specific consequences in the EU, particularly in the Euro Area. The reason for this fact is related to the weak coordination of economic policies within EMU which, during the first 10 years of the euro, was unable to smooth the existing significant disparities among its member states in terms of competitiveness, potential growth and living standards. Imbalances remained and accumulated within the Euro Area generating significant surpluses in more competitive economies and increasing the level of indebtedness in less developed and less competitive economies. The emergence of the so called sovereign debt crisis made clear that the Euro Area was not prepared neither to prevent, nor to solve a crisis of this dimension. Markets became more averse to sovereign risks and reduced their willingness to be exposed to such risks on countries considered to have levels of debt too high and likely to become unsustainable. As a consequence, several Euro Area member states faced difficulties in obtaining the necessary financing under current market conditions and were forced to ask for financial support to the EU and the IMF. Adjustment programs imposing fiscal targets and structural reforms were designed imposing a very strict conditionality and surveillance to these countries.

Soft economic governance, absence of fiscal instruments aimed at crisis resolution together with slow policy reaction from the EU decision-making institutions contributed to the momentum of the crisis. The EU was slow to understand that the crisis was not a simple liquidity crisis, but rather a solvency crisis for which there were no instruments able to respond. Slow to understand the implications of the sovereign debt crisis on the banking sector and the build up of a negative loop between them, spreading and aggravating the scope of the crisis. Slow to understand that, without EU fiscal instruments and policies supporting countries subject to the conditionality of
adjustment programs, there is a recessionary austerity bias in EU policy. The contractionary effects of this bias jeopardise the achievement of fiscal targets, compromises the prospects for debt sustainability, and undermines the political and social support required for the full success of such programs. The initial program designed for Greece was neither successful nor credible. Greece had to restructure its debt and an additional financial package was needed. Difficulties in the implementation of the program are apparent, economic and social costs in terms of output loss and unemployment are high, risks of political and social unrest are sizeable, and there is the perception that it takes much longer than expected to meet the projected targets in the program. Similar difficulties are being faced by Portugal. The austerity imposed under the adjustment program caused an unprecedented recession with a sharp increase in unemployment. This recession has created difficulties in meeting the fiscal targets and the public debt increased beyond initial projections. In the meantime, political and social conditions deteriorated undermining the support and the credibility of the program.

These difficulties clearly point to the fact that within the EMU, there is a need for stronger fiscal institutions and policy instruments. Imbalances in some of the Euro Area member states are mirrored by imbalances of the opposite sign in other member states. This requires a coordinated adjustment policy involving all members of the Euro Area. Focusing in individual member states adjustment leads to an austerity-trap situation that affects the performance and stability of the Euro Area as a whole and, ultimately, the credibility of its institutions.

In the following section the paper analyses the economic governance framework of EMU and its inability to promote the real convergence of its economies. The effects of the crisis in Euro Area member states is analysed in section 3. In section 4 the focus is put on Portugal in the context of its historical imbalances. The implications of the crisis in Portugal and the difficulties concerning the implementation of its adjustment program are analysed in section 5. A brief conclusion closes the paper.

2 - EMU, Macroeconomic Imbalances and the (Un)Coordination of Economic Policies

The creation of the European Monetary Union (EMU) aimed the establishment of a macroeconomic framework in which member states would benefit from higher

1 The IMF has recently recognized that there were mistakes in the initial assessment of the Greek situation.
nominal stability in their economies, and improved coordination and governance of their economic policies. This macroeconomic environment would promote higher integration of markets, namely financial markets, and improvements in competitiveness, growth, employment creation, and well-being of its citizens. Together with the nominal convergence required to launch the euro, EMU was expected to provide for greater real convergence of the participating economies.

After ten years, this has not been the case. Figures 3.1 and 3.2 clearly show that disparities in productivity remained significant and that asymmetries in GDP per capita levels have increased between 1999 and 2008.

Disparities among countries regarding competitiveness, growth potential, flexibility and competition in their markets, were not smoothed. On the contrary, they persisted originating important imbalances within the Euro Area. The figures below illustrate this fact, emphasizing the contrast between the peripheral members of the Euro Area (Portugal, Spain, Greece, Italy and Ireland) vis a vis the other members in central and northern Europe (Germany, France, Austria, Netherlands, Belgium, Luxembourg and Finland). The behavior of the real effective exchange rate emphasizes the difference regarding competitiveness developments. Peripheral countries, due to higher wage and price increases had an appreciation of the real exchange rate, namely after the introduction of the Euro when they became unable to use the nominal exchange rate to offset negative developments affecting their competitiveness. The current account balance reflects the resulting imbalances within the Euro Area. While the peripheral countries accumulated deficits, the central/northern members accumulated surpluses which implied a significant accumulation in foreign financial assets and, thus, an increase in their net international investment position.

Such imbalances within the Euro Area would have required a coordinated policy response aiming at their correction. Surplus countries should have conducted more expansionary policies, and deficit countries should have promoted savings and structural reforms to improve competitiveness in their economies. The absence of an effective coordination of national economic policies in the Euro Area, together with the

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2 The aggregate values for the two groups of countries are a weighted average of the figures for the countries included, where the weights are the average share of each country GDP on the total GDP of the corresponding group over the period 1999 to 2008. On these imbalances, see Nils Holinski, Clemens Kool, and Joan Muysken “Persistent Macroeconomic Imbalances in the Euro Area: Causes and Consequences”, Federal Reserve Bank of St. Louis Review, January/February 2012.
lack of national commitment, allowed for the persistence of those imbalances. Indeed, the economic governance of the Euro has been asymmetric. On one side, there is a single monetary and exchange rate policy, but, on the other side, there are different economic national policies aiming at national goals and subject to different national political incentives and constraints. The Stability and Growth Pact (SGP), with the imposition of rules and sanctions, intends to promote discipline in the conduct of national fiscal policies. But in what concerns other economic policies coordination relied on a procedure involving recommendations to countries enacted by the European Council (Broad Economic Policy Guidelines). Under this framework, member states were subject to enhanced surveillance and pressure to meet fiscal targets. But that was not the case for other economic policies, namely, structural reforms to foster competitiveness, growth, and a more balanced Union among its members. They were only subject to soft coordination\(^3\).

Progress in the integration of European Union financial markets was important to the effective transmission of the single monetary policy to member countries. This integration eased the flowing of funds from surplus to deficit countries. Markets were easy in lending to deficit economies and had not differentiated, in a significant way, among them. It is known that, when the Euro was launched, some of the member countries had public debt ratios well above 100% of GDP. However, the perspectives of improved growth raised by the launching of the single currency, within a framework of improved fiscal discipline provided by the SGP, made very unlikely a scenario of default of any of its members. Until 2008, interest rate spreads narrowed and were more the result of differences in liquidity of bond markets rather than risk differentiation among sovereigns.

External imbalances within the Eurozone were, thus, regarded as no big problem. Indeed, the balance of current transactions of the Euro Area, as a whole, has been fairly close to balance, although there have been imbalances among member states. The absence of peer and political pressure under the soft economic governance model of the Euro Area, together with the easy, and cheap, financing of the deficits in the weaker economies, did not generate the appropriate incentives for the promotion of the needed structural reforms. As money flowed so easily, some economies (governments

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\(^3\) This is something the EU intends to correct with the recent launching of the Macroeconomic Imbalance Procedure. For many years, the items in the Ecofin and Eurogroup agendas focusing on the surveillance of fiscal policies were those deserving much more attention as compared to those related to the Broad Economic Policy Guidelines.
and private sectors) were able to afford delaying such reforms. There was no sense of urgency in correcting those imbalances.

3 - The asymmetric consequences of the current financial and economic crisis

The subprime crisis of 2007 was a trigger of a broader financial crisis with severe economic consequences. Due to deficiencies in risk assessment, to high leveraging of financial institutions and to regulatory and supervisory failures, financial institutions were exposed to high risk assets which implied substantial losses and failures. Difficulties in assessing counterpart risks led to a loss of confidence in financial markets, a quasi-paralysis of interbank money markets, and a credit contraction with negative impacts on economic activity.

At EU level, authorities soon expressed their concerns on the financial and economic consequences of the crisis and defined a coordinated policy response. The coordinated response of policymakers aimed at the following major goals:

- the stability and the recovery of confidence in the financial system. This involved initiatives to reforming regulation and supervision of financial activities as for example the creation of the European Systemic Risk Board, the creation of EU-wide regulatory authorities in banking, insurance and securities markets, legislative initiatives such as Solvency II, the Capital Requirements Directive (Basel III), the creation of the Financial Stability Board, etc;

- the solvency and access to liquidity of financial institutions. State money was made available for capital injections and state guarantees were provided as collateral for refinancing operations of banks. Central banks improved their cooperation aiming at a better coordination of their interventions in monetary markets;

4 "... We agree to coordinate closely in our actions and to take into consideration potential cross-border effects of national decisions. We agree that public intervention has to be decided at national level in a coordinated framework."

"To protect the depositors’ interests and the stability of the system, we stress the appropriateness of an approach including, among other means, recapitalisation of vulnerable systemically relevant financial institutions."

(Council of Economic and Financial Affairs, Luxembourg, 7 October 2008).

"The European Council agrees on a European Economic Recovery Plan, described below. The plan will provide a coherent framework for action to be taken at the level of the Union as well as for measures adopted by each Member State, taking account of their individual circumstances. In line with the Commission communication of 26 November 2008, it is based on an effort equivalent in total to around 1.5 % of European Union GDP. It also envisages the initiation of priority action to enable our economies to adjust more rapidly to current challenges."


5 More recently, major banks have been subject to stress tests and banks were required to increase their core tier 1 capital ratios. In this context, banks, and the private sector in general, have engaged in a deleveraging process implying a slowdown, and in some cases, as in Portugal, a decline in the stock of credit to the economy. Presently, EU authorities are in a process to creating a banking union which will imply a single rulebook and a single EU-wide supervisor for major banks.
to promote a fiscal stimulus to counteract the recessionary effects of the financial crisis. This was the case, for example of the European Economic Recovery Plan launched in the end of 2008, and the Recovery Plan presented by president Obama in early 2009.\(^6\)

Public finances reflected these efforts together with the impact of automatic stabilizers (namely the fall of tax revenues). General government deficits and debt to GDP ratios increased sharply between 2007 and 2009 in Europe and other major economies in the world. Deficits were, on average, aggravated by 5.7 percentage points of GDP in the Euro Area, 8.7 in the UK, 9.1 in the USA and 6.8 in Japan. Greece, Spain, Ireland and Portugal had an increase of 9.2, 13.1, 13.9 and 7.0 percentage points respectively. The ratio of public debt to GDP jumped 13.6 percentage points in the Euro Area, 23.6 in the UK, 22.7 in the USA and 27.2 in Japan. In Greece, the public debt to GDP ratio was increased by 22.5 percentage points, by 17.6 in Spain, by 39.8 in Ireland and by 15.3 in Portugal. (Figures 3.6 and 3.7)

When the Euro was launched, several economies had high debt to GDP ratios. In particular, Greece, Italy and Belgium had ratios above 100% of GDP. For several years, the absence of EU common fiscal instruments for crisis resolution, namely the absence of a lender of last resort, was not perceived as being a problem. Apparently, markets believed that the monetary union, together with the integration of financial and monetary markets, would promote the convergence of her economies in terms of competitiveness and growth potential. However, the deterioration of fiscal positions in the Euro Area member states triggered a strong reaction from markets.\(^7\) With the emergence of the Greek crisis, markets became aware that, within the monetary union,

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\(^6\) International organizations, namely the IMF, recommended counter-cyclical policies to promote economic growth. In December 2008, in the IMF Staff Position Note “Fiscal Policy for the Crisis”, Antonio Spilimbergo, Steve Symansky, Olivier Blanchard, and Carlo Cottarelli state “The current crisis calls for two main sets of policy measures. First, measures to repair the financial system. Second, measures to increase demand and restore confidence. While some of these measures overlap, the focus of this note is on the second set of policies, and more specifically, given the limited room for monetary policy, on fiscal policy.” In March 2009, Charles Freedman, Michael Kumhof, Douglas Laxton, and Jaewoo Lee in the IMF Research Department paper “The Case for Global Fiscal Stimulus” state “Global fiscal stimulus is essential now to support aggregate demand and restore economic growth. The International Monetary Fund has called for fiscal stimulus in as many countries as possible, including emerging market and advanced economies.” The OECD also recommended active policies to face the recessionary effects of the financial crisis together with structural policies to promote sustainable long term growth (see “OECD Startegic Response to the Financial and Economic Crisis: Contributions to the Global Effort”, 2009).

\(^7\) Paul de Grauwe and Yuemei Ji (2013) argue that markets were led by fear and panic, pushing spreads to high levels and forcing countries to adopt austerity driven policies with very negative consequences in their economies.
without no lender of last resort and without domestic monetary and exchange rate policies, countries with high general government deficits and debts would not be able to correct their imbalances on a timely way and to ensure a sustainable path to their public finances. Markets realised that the "no bailout, no default, and no exit" trilogy foreseen in the treaties is inconsistent and bet that it would be broken. With the Greek crisis became clear that the EU, particularly the Euro Area, had no means to help Greece in the resolution of her crisis. Member states had to coordinate and to mobilize a set of bilateral loans to provide Greece with financial resources\(^8\). The conditionality imposed to the Greek authorities and the financial conditions of the loans in terms of maturity and interest rate were very strict. It was apparent that Greece would have great difficulties in meeting such demands in the given short period of time. The perception from markets that the EU/Euro Area was not prepared to respond to such crisis, the perception that the rescue package for Greece would hardly be successfully implemented, compromised the attempt to prevent the contagion of the crisis to other member states, namely to those with higher deficits and debts - Portugal, Ireland, Spain, and Italy\(^9\). Ireland requested financial assistance in November 2010. Portugal requested such support in April 2011. In February 2012, a second package was decided for Greece. Spain and Italy have been under market pressure, namely regarding the robustness of their banks. In mid-2012 Spain and Cyprus asked for financial support to recapitalize their banks.

An abrupt change in markets’ assessment and pricing of risk has occurred during the crisis. Markets started differentiating among Euro Area countries in a way they never did before. This is clearly reflected on the evolution of the spreads on the ten-year sovereign bond yields. Previous to the subprime crisis started in 2007, markets appear not to differentiate sovereign risks across Euro Area member states. This differentiation became evident since the failure of Lehman Brothers, and became even more significant since the outburst of the Greek crisis (see Figure 3.8). Markets became more and more concerned with the sustainability of sovereign debts. Spreads started

\(^8\) Curiously, in May 2010, in the same day the bilateral lending contracts were celebrated with Greece, Euro Area Member States decided to create the European Financial Stability Facility (EFSF). This was a transitory facility aimed at financing sovereigns with difficulties in the access to financial markets. In 2011, was decided to establish a permanent facility for this purpose, the European Stability Mechanism (ESM).

\(^9\) In October 2010, chancellor Angela Merkel and president Nicholas Sarkozy, after a french-german summit in Deauville stated that restructuring of sovereign debts would imply the private sector involvement. This was a strong incentive for investors to move away the sovereign debt of countries under stress.
reflecting the reaction of markets to the levels of public debt and to the interest rate/growth differential.

Figures 3.9 and 3.10 illustrate the relation between the average spread on ten-year sovereign bond yields, vis a vis the corresponding German yield, and the average debt to GDP ratio, and between that average spread and the average interest rate/growth differential in Euro Area initial member states\(^{10}\). The figures illustrate those relations for the periods 1999 to 2007 and from 2008 to 2012. They clearly illustrate the mentioned change in market behavior.

All in all, the impacts of the crisis were uneven across countries. The crisis has been an asymmetric shock affecting the financial conditions of sovereigns. As long as monetary and financial conditions became highly differentiated across countries, markets were segmented, namely in what concerns the peripheral member states. The progress, so far, regarding the integration of the Euro Area monetary and financial markets was destroyed. This segmentation became a clear threat to the conduct of the single monetary policy because sharp differences among countries in terms of interest rates and liquidity jeopardize its effectiveness. This adds to the mentioned asymmetric effects of the crisis across EU member states.

Indeed, this should not be a surprise given the existing structural differences and imbalances in their economies, namely with respect to the levels of indebtedness. Eurozone economic governance was mainly focused on fiscal discipline. Asymmetric developments in competitiveness and growth among members have not been addressed as seriously as fiscal imbalances. The Stability and Growth Pact provided incentives for fiscal discipline, however, as for competitiveness and growth only recommendations were issued. No peer pressure and no incentives existed for correcting such imbalances. Easy financing, soft Euro Area governance and lack of national commitment delayed the needed structural reforms to correct macroeconomic imbalances, improve competitiveness and foster growth. The case of Portugal is a good illustration of this.

\(^{10}\) The Luxembourg is not included because until May 2010 there was no public debt with a maturity near 10 years.
4 - Macroeconomic imbalances in Portugal in historical perspective

Since the reestablishment of democracy in 1974, Portugal has recorded significant macroeconomic imbalances. The collapse of the Bretton Woods fixed exchange rate system and oil shocks together with political, economic and social instability in the years following the April, 1974 "carnations revolution" generated domestic and external imbalances in the Portuguese economy. Sharp increases in unit labor costs and increasing domestic demand, fueled by expansionary policies and by the substantial increase of the resident population\textsuperscript{11}, in the context of a more unstable economic and financial external environment, generated increasing deficits on the foreign current account together with fiscal deficits, high inflation and increasing unemployment. External deficits originated sharp reductions on foreign exchange reserves forcing Portugal to negotiate two programmes of financial assistance with the IMF (1977-1979 and 1983-1985). Contractionary policies were then implemented, real wages fell sharply and the national currency (the escudo) was substantially devalued. With these policies, competitiveness was restored and the current account deficit was temporarily eliminated.

Figures 3.11 and 3.12 illustrate the developments in Portuguese competitiveness indicators. Figures 3.13 and 3.14 illustrate the major imbalances in the current account as well as in the fiscal position of the country for the periods before 1986 (previous to the integration in the European Economic Community), between 1986 and 1998 (before joining the euro), for the period within EMU from 1999 up to 2007, and for the crisis years from 2008 to 2010.

Real unit labor costs had a sharp increase until 1976 originating a significant appreciation of the real effective exchange rate. The two IMF programmes curbed down real labor costs and the real exchange rate depreciated in the late seventies and early eighties. However, these programs did not focus on structural reforms of the economy. Rigidities in labor, and goods and services markets remained and affected negatively the competitiveness of the Portuguese economy. Appreciation of the real effective exchange and external deficits remained during the following decades.

After joining the European Economic Community in 1986, trade deficits persisted, although lower than those recorded in the previous period. The high level of net

\textsuperscript{11} In the years 1974 to 1976 more than six hundred thousand people returned to mainland from the former Portuguese colonies, representing an increase of the population of more than 6\%.
transfers from abroad, namely remittances of emmigrants and transfers from the European Community, helped by the inflow of foreign direct investment, allowed Portugal to face the needs of its external payments, namely until the mid-nineties, without substantially aggravating its external indebtedness.
The years following the adhesion to the EC (1985 to 1990), as well as during the changeover years to the Euro (1995 to 2000), fed optimistic expectations on a sustained improvement in life standards. These expectations, together with the sharp decline in nominal and real interest rates, and the expansionary policies conducted during those periods created an unprecedented wealth-effect with a major impact on domestic demand, namely consumption, and savings.
Such expansionary policies reflected in the maintenance of high fiscal deficits in the eighties and nineties. Despite the discipline imposed by the Stability and Growth Pact since 1999, the average fiscal deficit between 1999 and 2007 was 4,1% of GDP. As of 2009, fiscal deficits increased substantially reflecting the impact of both the countercyclical policies promoted between 2008 and 2009 and automatic stabilizers.

Until joining the European Monetary Union in 1999, the devaluation of the escudo was intensively used to offset the negative effects on Portugal’s competitiveness from increases in nominal and real unit labor costs above those of its partners. Since 1992, within the European Exchange Rate Mechanism, the use of exchange rate devaluations to improve competitiveness became more difficult and, finally, no longer possible within the Euro Area. Structural reforms to improve labor market performance and foster productivity became of utmost importance to correct these imbalances and to promote growth. In addition, after joining the euro, Portugal was subject to two important asymmetric shocks in the last decade: (i) the liberalization of trade between the EU and China, when this country joined the WTO, and (ii) the enlargement of Union. Despite these shocks, the trade balance did not worsen when compared to the previous decade. However, the current account aggravated its deficit due the decline in net transfers and to the deterioration in the primary income balance.
The correction of these deficits required a major improvement in the trade balance throught gains in competitiveness. However, those reforms did not occur at the required pace, competitiveness did not improve, and current account deficits persisted pushing portuguese debt to higher and higher levels. Indeed, in the context of the single currency, with easier access to pan-european monetary and financial markets,
external imbalances reflected more and more in the increase of indebtedness. Private indebtedness increased sharply since the mid-nineties. From a level of 83,4% of GDP in 1995, private debt increased to 148,7% in 1998. When the crisis started, this ratio was 222,6% in 2007 and almost 240% in 2008. In what concerns the public debt ratio, the average of the public debt ratio increased from an average level of 32,2% in the years previous to joining the European Community, to an average of 54,9% of GDP in the years between 1985 and 1998. During the final years of this period, significant proceeds from privatizations allowed to keep this ratio at a level below the reference value of 60% of GDP. After joining the euro, the persistence of fiscal deficits ended up increasing this ratio from 51,8% of GDP in 1998 to 68,4% in 2007 and 71,7% in 2008. (see Figure 15).

As of 2005, policies aimed at reducing fiscal imbalances, strengthening the sustainability of public finances and improving the competitiveness of the Portuguese economy. Reforms in the social security system, in public administration, and in the labor market were implemented. Policies to improve the efficiency and effectiveness of the educational system, to foster research and development, technological progress and innovation were also implemented. The fiscal balance improved, the general government debt ratio slowed down, indicators on the sustainability of public finances improved, the appreciation of the real exchange rate was halted and exports gained momentum.

5 - The crisis and the Portuguese/EU/IMF/ECB adjustment program

The crisis started in late 2007 halted the effects of these reforms and ended up having a negative effect in public and private indebtedness. The general government deficit increased to 10,1% of GDP in 2009 and 9,8% in 2010. In this year, the public debt increased to 94% and private debt was almost 250% of GDP. As a consequence, the net international investment position of the country deteriorated to -107,2%.

The impact of the crisis in Portugal is not surprising given the referred historical record of macroeconomic imbalances:

- loss of competitiveness during the two decades prior to the crisis;
- high current account imbalances;
- decline in savings and increasing private indebtedness, namely external;
- persistent fiscal imbalances, with negative effects on reputation and credibility.
These fragilities and the concerns generated by the Greek situation provided momentum to the development of the crisis in Portugal. Markets became more and more reluctant to be exposed to Portugal’s risk and spreads on government bonds reflected these concerns (see Figure 8, above).

The high pricing of sovereign risks imposed by the markets had a significant contagion effect on the financial sector. Banks have recorded significant imparities/haircuts on their holdings of sovereign debt with important effects on their profitability and solvency. Banks' ratings have been negatively affected, limiting their ability to refinance their activity and, consequently, constraining liquidity. The contagion of the sovereign debt crisis on the financial sector has imposed the need for banks to recapitalise and deleverage their balance sheets.

Portugal attempted to avoid the contagion effects of the Greek crisis. In May 2010, immediately after the "rescue package" for Greece was decided and the European Financial Stability Facility (EFSF) was created, Portugal announced more ambitious fiscal targets for 2010 and following years, speeding up the process of fiscal consolidation. Additional fiscal measures were announced and implemented. The budget proposal for 2011, presented in mid-October, introduced sizeable cuts in expenditure and increases in taxes to meet such revised targets. However, the deterioration of the Greek situation pointing to an inevitable restructuring of the sovereign debt, the demands of private sector involvement in restructuring operations\textsuperscript{12}, and the rescue of Ireland in November, increased the pressure on the "next weak piece" in the ongoing Euro Area "domino effect": Portugal.

The Portuguese authorities intended to frame their response strategy within the "comprehensive strategy" to preserve financial stability that was being designed at the Eurogroup level\textsuperscript{13}. In the context of an enhanced surveillance, involving the Commission and the European Central Bank, Portugal demanded an assessment of its

\textsuperscript{12} These demands were coming, namely, from Germany, Finland, the Netherlands and were supported by France in the already mentioned German-french summit in Deauville.

\textsuperscript{13} On February 4, 2011, the heads of state and government of the Euro Area and the EU institutions, issued a statement on this strategy. According to this statement, the strategy would include the initiatives reinforcing the economic governance of the euro, stress tests and financial sector repair, the implementation of the European Semester and the following steps:

- Continued successful implementation of the Greek and Irish programmes.
- Assessment by the Commission, in liaison with the ECB, of progress made in euro area Member States in the implementation of measures taken to strengthen fiscal positions and growth prospects.
- Concrete proposals by the Eurogroup on the strengthening of the EFSF so as to ensure the necessary effectiveness to provide adequate support.
- Finalization of the operational features of the European Stability Mechanism.
fiscal situation and the design of fiscal measures and structural reforms aiming at improving fiscal and growth prospects. The Portuguese authorities, with the cooperation of the Commission and the ECB, defined a program of fiscal and structural measures aiming at preventing the worsening of market conditions for Portugal and enabling the country to ensure its access to market financing. This program had a strong political support from the Commission, the ECB and major member states. Once under implementation, this program would enable the ECB to intervene on secondary sovereign bond markets.

In March 2011, the Portuguese Parliament refused political support to that program. Following this refusal, the prime minister resigned and an early election was called. The political instability resulting from these events, and the uncertainty it created in markets, implied successive downgrades of the country's ratings as well as of major banks. Obtaining the necessary financing under current market conditions became more and more difficult and the exposure of banks to Portugal’s risk became unbearable\footnote{On the effects of the crisis on the private flows of capital see Silvia Merler and Jean Pisani-Ferry "Sudden Stops in the Euro Area", Bruegel Policy Contribution, March 2012.}. In April 6, the government announced that Portugal would request financial assistance from the EU and the IMF. The program agreed with the EU and the IMF will provide until mid-2014 a total financing of 78 billion euros and imposes a very strict conditionality. Largely based on the refused preventive program, this program defines a wide set of measures: (i) fiscal adjustment and sustainability of public finances, (ii) ensure the stability and soundness of the financial system, and (iii) structural reforms to improve competition, for greater labor market flexibility, to improve doing-business conditions and business environment, and to enhance competitiveness and growth in the medium/long-term. The program includes several institutional reforms on the budgetary framework improving governance, transparency, surveillance and control of fiscal risks. Privatisation and deregulation of markets, namely on energy, telecomunication, and housing sectors. Reform of the judicial system improving efficiency and effectiveness of the court system.

The program demands the deleveraging of the public and private sectors of the economy. Both the general government and the private sector - households, banks and non financial companies - have raised savings and reduced their financial needs.
Fiscal policy targets main targets are the reduction of the deficit to levels in line with the Euro Area medium term objective of a structural balance above -0.5% of GDP. In 2015, the fiscal balance target is -2.5% of GDP, corresponding to a projected structural deficit of -1.1% of GDP. Between 2012 and 2015, the deficit has to be reduced by 3.9 percentage points of GDP (2.9 percentage points in structural terms). This fiscal adjustment is of utmost importance to ensure sustainability conditions for the debt to GDP ratio. According to the projections of the IMF/EU, assuming that real GDP growth recovers and reaches an average annual rate of 2% by 2020, so that annual nominal GDP growth will be around 4%, and that the interest rate on the public debt falls to 5% until 2017, the sustainability of the Portuguese public debt requires a structural primary surplus of 3% of GDP a year. Under these assumptions, the debt to GDP ratio will decline to 94% in 2050 and to nearly 82% of GDP in 2030.

Figures 3.17 and 3.18 indicate the observed budget balance and debt/GDP ratio in recent years as well as the targets that have been defined for the next years. From 2009 to 2012, the budget deficit was reduced by 3.8 percentage points of GDP (a reduction of 5.3 percentage points in the primary balance and of 5.2 percentage points in the structural balance). In structural terms, the balance in 2012 fell short of the -2.4% target previously defined for the year. This reflects the impact of the deeper recession on fiscal outcomes, namely on fiscal revenue and unemployment benefits, and the consequent difficulties in reaching the targets defined.

In what concerns the stability and soundness of the banking system, banks have been under a sizeable deleveraging process. Banks have improved their capital ratios. The capital adequacy ratio of banks has increased from 9.8% in 2011 to 12.6% in the end of 2012. The core tier1 ratio increased from 8.6% to 11.3% during that same period. However, deleveraging has had a negative impact on the flow of credit to the economy. In the first quarter of 2013, the year on year rate of growth of total domestic credit was -8.2% (-8.2% on credit to non-financial corporations and -4.0 to households).

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15 These projections have been revised recently. The previous projections were more ambitious. In April 2012 (Third Review of the Program) they were the following:

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<td><strong>Budget Balance</strong></td>
<td>-4.5%</td>
<td>-3.0%</td>
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<tr>
<td><strong>Structural Budget Balance</strong></td>
<td>-2.4%</td>
<td>-0.9%</td>
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Fiscal policy has reduced government consumption and transfers, and taxes have been raised implying a reduction on households disposable income. The deleveraging of banks has been sizeable and has implied a reduction on the stock of credit. The effect of these policies on aggregate demand is illustrated in Figure 3.20. Private and government consumption declined as well as gross investment, implying the decline of domestic demand. On the other hand, net foreign demand has been fueled by increasing exports and by the fall in imports resulting from lower domestic demand (see Figure 3.21). This improvement on net foreign demand has not been strong enough to offset the fall on domestic demand, and real GDP has declined since 2011. As a result of the recessions of 2009 and 2011-2013, unemployment has increased sharply during this period (Figure 3.22).

Two years after the implementation of this program, the costs are well perceived by the population. The ongoing adjustment under the conditionality imposed by the EU/IMF/ECB is imposing significant costs in terms of output loss and increased unemployment. The positive outcomes are not so perceptible. Difficulties in reaching the fiscal targets, reflected in its revision and extension of the period of adjustment sustain the expectation that austerity oriented policies will remain prolonging the period of low growth and high unemployment. This is undermining the political and social support to the adjustment program.

The difficulties encountered in the implementation of the Portuguese Adjustment Program clearly illustrate that countries with no national monetary policy nor lender of last resort and unable to manage the exchange rate are forced to an austerity bias imposing high social and political costs. As long as they are part of a monetary union implying the delegation of important policy instruments to supra-national entities, they cannot be left alone bearing the costs of the adjustment. It is clear that this is a crisis affecting the Euro Area as a whole and its resolution cannot rely almost exclusively on the national adjustment policies. The lack of Euro Area-wide policy instruments and institutions, namely on the fiscal side, the absence of a lender of last resort is imposing a high burden on member states. Progress towards a stronger fiscal pillar to support the Euro is clearly the issue, unfortanetelly an issue, and a challenge, that EU politicians are not yet willing to face.
5 - Conclusion

The European Monetary Union was unable to promote the real convergence of the Euro Area economies. The existing asymmetries among them when the euro was launched persisted or were even aggravated in the following years. As a consequence of competitiveness and growth disparities, macroeconomic imbalances occurred within the Euro Area which reflected as an accumulation of liquidity in surplus countries and an increase in indebtedness in deficit countries.

The economic governance framework of the Euro has focused on the single monetary policy and on fiscal surveillance and conditionality under the Stability and Growth Pact. It has neglected economic and structural reforms aiming at boosting competition and growth in member states economies.

The financial crisis had, in consequence, asymmetric implications within the Euro Area. Less competitive economies, more indebted and with lower growth prospects were particularly penalized by markets when confronted with the increase of their deficits and debts. Portugal was particularly affected by these events. For decades, competitiveness was undermined by unfavorable unit labor costs developments. Loss of competitiveness together with lower net transfers from abroad and higher net external payments of primary incomes have kept the deficit of its current account at high levels. In other words, national savings were short to meet the financing needs of the country. Consequently, the level of indebtedness of the country increased overtime. Persistent external and fiscal imbalances, lower growth prospects determined by non competitive market structures and rigidities in the labor market, determined a negative assessment of the country’s sovereign risk in face of the deterioration of the fiscal position occurred in 2009/2010. The change on markets' risk pricing of Portugal slowed down the private flows of capital into the country raising difficulties in ensuring the necessary financing under the current market conditions.

Since 2011, Portugal is implementing an adjustment program, under the surveillance of the EU, the IMF and the ECB, imposing strict conditionality in the conduct of national economic policies. The current account deficit has been so far eliminated and the structural fiscal position has improved. However, the long and deep recession imposed by the austerity-biased program is keeping the country away from the projected targets. Increased unemployment and prolonged austerity is undermining the political and social support to the ongoing policies. The implementation of the Portuguese clearly illustrates that there is a need for enhanced Euro Area fiscal instruments and
institutions to overcome the current crisis.
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Figure 3.5: Net international investment position in EA12 (% GDP)
Figure 3.16: Net International Investment Position (%GDP)

Figure 3.17: General government budget balance
Figure 3.22: Unemployment Rate