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Causes, consequences, and ways out of the crisis: a perspective from EU's periphery

Portuguese economist Ricardo Paes Mamede examines the structural issues at the heart of the eurozone crisis as it affects Portugal. As the austerity path fails to provide a lasting, or even immediate, solution, Mamede discusses alternative measures to maintain Portuguese stability within the Eurozone system and support sustainable economic development.

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The crisis as a result of misgovernment?

The public debate in Europe about the current crisis is still dominated by the view that we are witnessing the results of systematic and prolonged misgovernment in the "crises countries". According to this view, the adoption of financially unsustainable public and private decisions over the years, together with the repeated postponement of "structural reforms" lie at the roots of the growing reluctance of private investors to buy the sovereign bonds of some European countries. The depletion of external sources of funding in a context of high levels of indebtedness of domestic agents eventually resulted in the inevitable need for financial aid from international institutions, which was necessarily accompanied by a set of demanding conditions for adjustment. Despite the high economic and social costs of adjustment in the short- and medium-term, the dominant view about the origins of the crisis holds that the rebalancing of public and private balance sheets fostered by the adjustment programs, and the "structural reforms" adopted in this context, will restore confidence in the crisis economies, giving rise to a new period of economic growth and enhanced social welfare.

Within this view on the origins and ways out of crisis, the role of the European rules and institutions is typically left unquestioned. True, it is now widely recognised that the recurrent ambiguity, hesitation, and difficulty in reaching agreements between the major European governments and institutions since 2008 have increased the levels of uncertainty among already nervous financial investors, leading to the worsening of the sovereign debt crisis in the euro zone. It this sense, it is now hardly disputed that the EU is ill-prepared to deal with extreme situations such as the current one. However, this consensus regarding the need to adjust the policy instruments to deal with huge crises at the EU level should not be confounded with the identification of the causes that led to the crisis on the first hand.

According to the dominant view, the current crisis results from the inability of national agents – in particular, governments – in the EU's periphery to make the right decisions in the framework of the prevailing EU rules and institutions; the only pitfall of the latter has been their incapacity to impose stronger discipline on national governments. In short, it is assumed that with essentially the same EU rules and institutions – complemented by a more stringent control of fiscal management by the Member States – the outcome could have been substantially different.

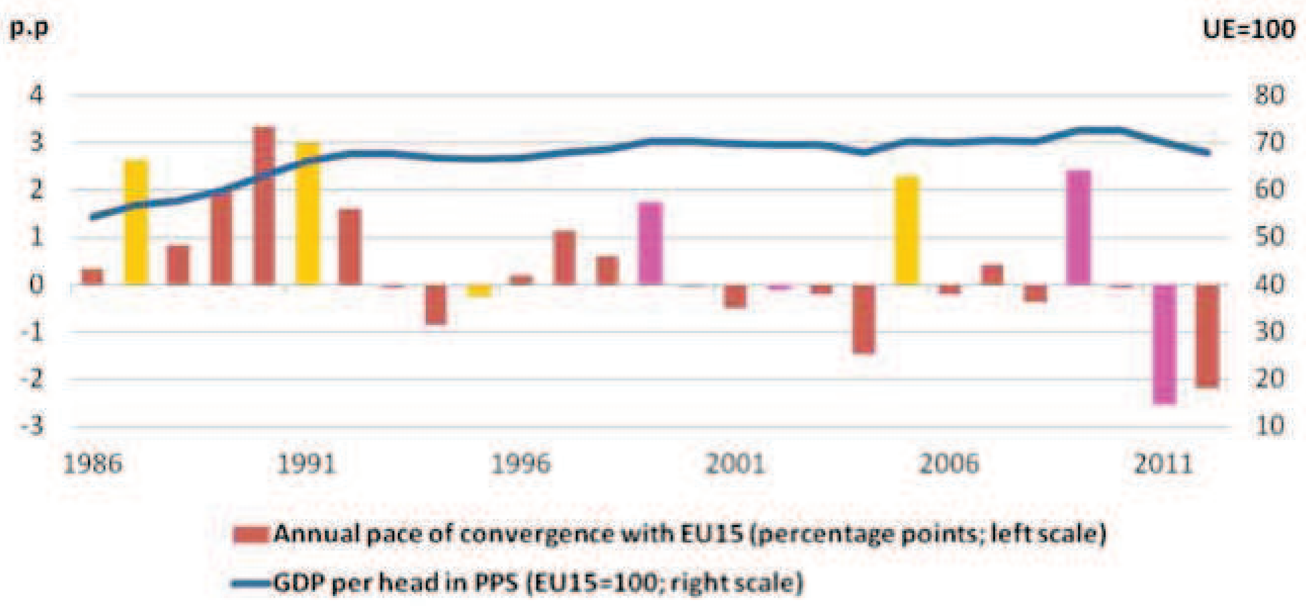
While it is impossible to exclude the misconduct of national governments from the explanation of the sovereign debt crisis in the euro zone, a closer look on how the crisis economies have evolved, and on the policies which were put in place in recent years, may lead one to question the simplicity of the dominant narrative. And once we consider the main aspects that ultimately led to the growing reluctance of private investors to lend to national governments, we may find ourselves questioning the appropriateness of the general austerity approach that has been adopted in the EU as the way out of the crisis.

This paper takes a closer look at the causes of the dismal performance of the Portuguese economy in the last decade, emphasising some crucial structural problems which have limited the capacity of adjustment in the face of successive external shocks. Once we consider these aspects, it becomes less obvious that the austerity approach can promote a sustainable way out of the crisis. Alternative approaches to deal with the crisis while promoting economic, social and environmental sustainability across the EU are discussed in the conclusions.

Dismal growth and its structural causes

The poor performance of the Portuguese economy is not a recent phenomenon. In the first half decade that followed the country's accession to the EEC in 1986, average incomes converged at a fast pace with those of the EU (*Figure 1*). However, even though economic growth remained generally positive until the turn of the millennium, real convergence with the EU average was virtually absent since 1992 – and has been reversed on several occasions after 2001. In 2012 the Portuguese GDP per capita (in purchasing power parities) in proportion to the EU15 average is expected to be identical to that of 20 years earlier (*i.e.*, about 68%).

Figure 1 - Evolution of the gap in GDP per capita (PPP) between Portugal and the EU15 since 1986



Since 1992, the pace of convergence with the EU15 has only been above one percentage point in four years – 1997, 1999, 2005, and 2009. Three out of these were years in which general elections took place, and the remaining one corresponds to the year preceding the Lisbon Universal Exhibition (Expo 98), a major event for which huge amounts of public and private resources were mobilised. In other words, in the few periods after 1992 in which there was significant convergence with EU15 income levels, this appears to have been achieved largely on the basis of arbitrary stimulus to domestic demand through public spending; this is especially true after the entry into force of the euro, in 1999.[1]

To some extent, the data presented above appear to support the prevailing view on the origins of the Portuguese crisis: in particular, the graph suggests that electoral considerations (and other motives, often unrelated to the promotion of economic, social, and environmental development) have been at the basis of fiscal practices which eventually proved to be unsustainable. However, the tendency for the periods of convergence to coincide with election years is only one of the main messages that can be extracted from Figure 1. Even more striking is the near absence of real convergence of the Portuguese economy with the EU average since 1992 – and particularly after 1999 – excluding very occasional moments.

While the economic performance of the country could have been somewhat different had the conduct of fiscal policies been less arbitrary, it is not reasonable to abstract from other deeper aspects underlining such performance. Despite all the controversies surrounding this discussion, there is broad consensus regarding the importance of three areas of structural weakness, which are inseparable from the dismal performance of the Portuguese economy in recent decades. Such structural weaknesses are: (i) the education level of the labor force, (ii) the profile of economic specialisation, and (iii) the peripheral position of the Portuguese economy in relation to the main European and world markets.

When Portugal joined the EEC in 1986 the proportion of working-age adults who had completed secondary education was less than 20% (while the European average was already close to 60%). This stunning figure is, to a large extent, an inheritance of nearly half century of conservative dictatorship (ending in 1974), which deliberately underinvested in general education. Overcoming this depressing legacy in education levels has become a main concern for public policy in the last two decades, leading to significant improvements in several areas. Notwithstanding, Portugal still has one of the lowest levels of education attainment in the OECD. Long-lasting habits of families' underinvestment in education, largely explained by the high levels of poverty and inequality in the country, have contributed to prevent a drastic reduction in the rate

1 In the second half of the 1990s, another relevant factor accounting for the convergence episodes was the substantial decrease in real interest rates, related with the anticipation of the euro (more on this below).

of early school drop-outs, slowing down the pace of convergence with more advance economies in education levels until today.

There are several implications of low education levels, both in terms of economic performance and of social progress. In particular, huge gaps in education are both a cause and a consequence of the second domain of structural weaknesses mentioned above – the specialisation profile of the Portuguese economy. At the time of joining the EEC, the Portuguese economic fabric was characterised by a huge weight of primary sector activities and low value added, low technology intensive manufacturing industries. The industrialisation of the country had been driven, since the early 1960s, by successive waves of foreign direct investment (FDI), which was driven by – and helped to deepen – such specialisation profile. At first, membership of the EEC and the prospects of a unified European market made the Portuguese industrial tradition (and the corresponding low wages) even more attractive to international corporations. However, with the rapid advance of the globalisation of production it became increasingly difficult to maintain the competitiveness of the Portuguese economy on the basis of low labour costs.

Moreover, the process leading to the Economic and Monetary Union, which started in the late 1980s, has been characterised by the priority given to stabilising the exchange rates within the EU (as a part of the so-called "nominal convergence" criteria). In practice, this led to an appreciation of the escudo (the former national currency) against the basket of relevant currencies by nearly 35% between 1986 and 1999. In other words, the increasing exposure to world competition was concurrent to a substantial increase in the exchange rate, both developments leading to a gradual erosion of competitiveness in the traditional sectors of the Portuguese industry.

At that time, many believed that the increasing difficulties in competing on the basis of price would constitute an incentive for the structure of the Portuguese economy to shift towards more sophisticated and promising activities. However, this restructuring path faced two crucial obstacles: first, the unavailability of qualified resources suitable for a rapid development of the most advanced, internationally competitive activities; second, the prevalence of several incentives for investors to target other types of (not so promising) activities.

In fact, on one hand, an overvalued currency contributed to ward off investors from tradable sectors. Moreover, such evolution in the exchange rates was paralleled by two other significant developments: the privatisation of large state companies (partly as result of EU rules) which were strongly oriented to the domestic market; and the sharp reduction in real interest rates since the mid-1990s (as a result of the aforementioned 'nominal convergence', in anticipation of the EMU). These three factors combined encouraged the channeling of an increasing share of resources to non-tradable activities – namely, financial services, transports, energy, telecommunications, construction, retail and distribution – to the detriment of investment in tradable goods' industries, postponing the expansion and upgrading of the Portuguese export sector.

Thus, the traditional specialisation of the Portuguese economy – based on low value added, low tech activities – remained virtually unchanged until the start of the euro.[2] These industries would be faced with three significant shocks in the subsequent period: (i) the entry of China into the WTO (and the related EU/China trade and investment agreements); (ii) the EU enlargement to the East; and (iii) the strong euro appreciation against the dollar between 2001 and 2008. The first two events have increased significantly the exposure of Portuguese industry to foreign competition (given the large overlap of export structures between the Portuguese and the emergent economies of Asia and Eastern Europe), while the euro's appreciation against the dollar eroded the price competitiveness of national exports (for which price is still a decisive performance factor).

In this context, the peripheral position of the Portuguese economy to the main EU markets – the third structural weakness mentioned above – became even more pronounced (as reflected, in particular, by the growing loss of attractiveness of FDI to the benefit of the enlargement countries).

Given the structural weaknesses and international developments aforementioned, the prevailing view, which holds that the present condition of the Portuguese economy is due to internal misgovernment, deserves consideration. It is difficult to sustain that Portugal would have been able to adjust smoothly – on the basis of the policy instruments available at the national level – to those developments. On the other hand, it hard to ignore the relevance of the rules and decisions taken at the EU level in shaping such developments as: the process leading to the single currency (implying a lengthy period of currency appreciation, coupled with the abrupt reduction of real interest rates); the management of monetary policy within the Euro (which assigns the highest priority to controlling inflation and neglects the exchange rate developments); international agreements on foreign trade and investment, and the EU enlargement to the East (the benefits and costs of which are asymmetrically distributed among Member States). In other words, at the very least one has to recognise that the distribution of the gains and losses of EU's developments and policy options in the last two decades were not especially favorable to a country like Portugal (and to countries with similar structural characteristics).

National misconduct put in perspective

The erosion of public finances and external accounts, as well as the increasing reluctance of foreign investors to finance Portuguese public and private entities, are first and foremost a result of a long period of dismal growth. This, as the discussion above

2 In the meantime, the primary sector – in particular, agriculture and fisheries – has registered a dramatic contraction, as a result of the low levels of productivity and the rules of Common Agriculture and Fishery policies, which created incentives for a drastic reduction in these sectors' productive capacity.

At this juncture, one should ask: is there a place for national misgovernment in the explanation of the current state of affairs?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suggests, is largely explained by the combination of historical structural weaknesses and international developments – part of which are directly associated with crucial dimensions of the European integration process and with decisions taken at the EU level. At this juncture, one should ask: is there a place for national misgovernment in the explanation of the current state of affairs?

Surely, it is possible to identify several decisions taken at the national level that contributed to jeopardise a sustainable growth path of the Portuguese economy. *Figure 1* already presented some evidence suggesting that public finances in Portugal may not have been managed in the most appropriate fashion. Although the tendency for governments to put forward expansionary fiscal policies in anticipation of general elections is far from being a specific Portuguese phenomenon, this does not mean that such practices are without consequences. More generally, one should ask whether greater restraint in the management of public finances, as well as other economic policy measures, could and should have been put in place in order to prevent the present crisis. Three topics often arise in the context of such discussion: the over-indebtedness by both public and private entities; the excessive generosity of welfare systems and wage increases; and the absence of "structural reforms" at the level of labour markets, product markets, and regulatory framework for business activity.

The issue of indebtedness is closely associated with the evolution of the real interest rate in the second half of the 1990s, in the anticipation of the euro and as a result of the priority attached at the EU level during in this period to "nominal convergence". In the case of Portugal, the drop in real long-term interests rates was rather dramatic, falling from an average of 4,8% in 1993-1996 to 1,8% in 1997-2000. This had a huge impact on public and private decisions, since economic agents were now able to obtain a substantially higher volume of credit without increasing significantly their future financial obligations. Accordingly, public and private (firms and families') investment increased at a fast pace during this period, feeding – and being fed by – economic growth.

In fact, the increase in domestic investment was concurrent to a period of low oil prices and favourable exchange rate developments (with the appreciation of the dollar against the euro), all of which had a positive impact on economic activity. Thus, after the GDP contraction in 1993 (in the wider

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context of the crisis of the European Monetary System), the Portuguese economy regained momentum, growing at an annual average of 4,6% between 1995 and 2000.

The good pupil of the European class

Such economic growth was to some extent translated into long-awaited improvements in social welfare. For example, between 1990 and 2000, the minimum old age pension increased from €163 to €202, while the minimum unemployment allowances increased from €257 to €334 (all values at 2006 prices), while access to health and education services by the population at large has improved substantially. When the decade drew to a close, government expenditures as a percentage of GDP had grown to 41,1% (from 38,5%) – still below the EU15 average of 44,9%, but much closer than in 1990.

Notwithstanding the increase in social expenditures, public accounts seemed at the time to remain in a healthy shape. In fact, national public debt decreased by more than 10 percentage points of GDP in the second half of the 1990, from 59,2% in 1995 to 48,5% in 2000. In other words, while the underdeveloped Portuguese welfare system has witnessed some convergence (albeit modest) towards EU standards during this period, the rapid pace of economic growth and the low levels of real interest rates allowed this to be compatible with a positive evolution of public finances.

In sum, by the turn of the millennium, the Portuguese economy and society were in seemingly promising conditions – and the participation in the founding group of the euro area was just another expression of this optimist outlook.

However, the evolution of the Portuguese economy was rather different afterwards, with GDP growth between 2000 and 2005 dropping to an annual average of 0,8%. A number of events account for this dramatic change of course. Soon after the inception of the euro, in reaction to what appeared to be signs of overheating in the euro zone, the ECB started to tighten its monetary policy, leading the Euribor 6-month rate (which is used as reference to most bank credits) to nearly double from its lowest 1999 value, reaching 5,2% in late 2000. Given the high rates of public and private investment in the preceding years, essentially financed through bank credit, the steep increase in the interest rates had a significant impact in the levels of available income and, consequently, in domestic demand. In the meantime, the busting of the "dot.com bubble" (starting in March 2000 and lasting through 2001) triggered the first international economic crisis of the new millennium. These two events are largely accountable for the increase of the Portuguese public deficit to 4,3% of GDP in 2001, making Portugal the first country in the euro area to break the Stability and Growth Pact's (SGP) 3% limit. In the following couple of years, the Portuguese authorities were committed to comply with the SGP rules, following pro-cyclical, contractionary fiscal policies, which led to a 1% drop in GDP in 2003 – starting a decade-long period of divergence in average incomes with the EU.

While the levels of public and private indebtedness looked relatively sustainable during the second half of the 1990s (when GDP was growing an at average annual rate of nearly 5%), a sequence of years of dreary GDP growth translated into rising debt ratios of firms and families, increasingly translated into lower investment – and, consequently, even lower growth. By this time, the Portuguese economy was facing the consequences of the aforementioned combination of structural weaknesses and international developments. In particular, the growing competition from Asian emerging economies (partly as a result of the agreements reached by the EU in the WTO and other forums) has had a substantial impact in a number of traditional industries (namely, textiles, wearing apparel, footwear, wood and paper, metal products and non-metallic minerals), which were responsible for a significant part of the manufacturing work force. Moreover, anticipating the EU's Eastern enlargement in 2004, a number of multinational firms (especially in the automotive and related industries) have de-located their productive capacity to some of the new member states (taking advantage of lower wages, higher educational levels, and the geographical proximity to the main European markets).

External shocks at the start of the new millenium

In short, steep increases in the interest rates (after a prolonged period of public and private investment), international crisis, pro-cyclical (restrictive) fiscal policies, increasingly fierce competition from emerging economies, and a loss of policy instruments to address such problems: this was the context in which the Portuguese economy entered the new millennium. When subsequent external shocks hit the international economy – namely the successive increases in ECB's interest rates in 2005-2008, the substantial appreciation of the euro against the dollar in 2007-2008, the peak in oil and commodity prices in 2008 and, finally, the Great Recession – Portugal was still going through an adjustment process characterised by low economic growth, rising unemployment rates (from nearly full-employment in 2000 – 3,9% – up to 7,7% in 2006) and, largely as a consequence, a steady rise in the public debt ratio (which surpassed the euro zone average for the first time in 2006, reaching 63,9% of the GDP).

During the first decade of the new millennium, several policy measures were adopted aiming to address the structural weaknesses of the Portuguese economy, its competitiveness problems, and the mounting challenges to the sustainability of public finances. For example: one of the most ambitious pension reforms in the EU was adopted in 2006 (which included a so-called 'sustainability factor' linking the minimum retirement age to life expectancy was introduced); the number of public servants has decreased continuously since 2005 and the public sector wages have grown systematically below inflation since 2001, contributing to the decrease in the public wage bill; European structural funds were redirected from physical infrastructure towards education and training (with Portugal presenting the EU's highest per capital level of the ESF in the programming period of EU's Cohesion Policy, 2007-2013), and to support firm investments in tradable activities; one of the most generous tax schemes to induce private R&D among the

OECD levels has contributed to a fast growth of corporate R&D (fostering the structural change of the economy); the substantial investment in e-government has put Portugal among the most advanced countries in the world concerning the de-materialisation of public services; the national renewable energies program led to one of the highest rates in Europe of renewables as a source of energy in consumption. As late as 2008, these and other policy initiatives were being praised by international organisations – including the European Commission, the OECD, and the IMF – as pointing in the right direction.

Other policy domains, often deemed relevant to tackling the problems of the Portuguese economy, did not merit the same degree of development, according to the institutions just mentioned. One point in case has been the labour market rules and developments. On one hand, labour market legislation has been considered too restrictive, namely in what concerns the formal conditions for, and the costs of, dismissals. On the other hand, the evolution of unit labour costs has been singled out as a source of loss in competitiveness for Portuguese exports. Both these aspects, however, should be put in perspective.

The prevalence of a dual labour market – characterised by the contrast between workers with regular contracts (benefiting from formal arrangements regarding social security, promotions, job protection, etc.) and those with more informal job arrangements (in which the benefits of regular contracts are nearly absent) – is often presented as a sign of inadequate labour market regulations. In the last two decades, the proportion of the Portuguese labour force working under "atypical" job arrangements has been growing steadily, a fact that is often presented in support of the need to change labour market institutions in Portugal. Regardless of the validity of this thesis – which is met with considerable criticism in the public debate – one should ask whether the supposed imperfection in labour market rules have had a significant impact on competitiveness.

In fact, it is hard to see that labour market institutions in Portugal have created significant negative incentives for investments and job creation. As mentioned above, by the turn of the century, Portugal was experiencing near full-employment, in contrast to many European countries. This seems to suggest that the Portuguese labour market institutions are far from being conducive to persistent unemployment. The steady growth in unemployment afterwards has been largely a result of an increasingly adverse macroeconomic context, as has been discussed above.

In the context of this discussion, it is often argued that wage developments were highly detrimental to Portuguese competitiveness. This echoes the widely spread idea of wage profligacy in the EU's periphery as a source of the current crisis, which is typically illustrated through the more rapid increase of real unit labour costs (RULC) in these countries with regard to the EU average (see *Figure 2*).

Especially in the case of Germany, wage repression as an instrument to improve competitiveness has resulted in an even sharper decrease in the wage share of income, with obvious delirious impacts on intra-EU trade imbalances.

Figure 2 – Real Unit Labour Costs (2000=100)

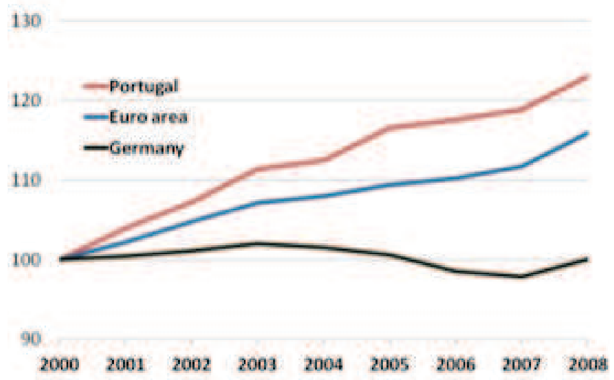
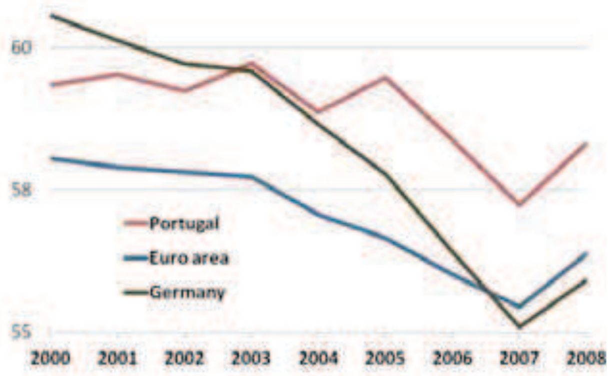


Figure 3 – Adjusted wage share of income (%)



One should note, however, that RULC measures the nominal average wage per unit of production. This means that the growth of RULC does not necessarily mean that *real* wages are rising faster than real product per hour worked – or that the share of wages in national income is increasing. In fact, the opposite is often true, as was the case in Portugal and in the EU as a whole, from 2000 to 2008 (*Figure 3*).

In other words, over this period (especially after 2005) real compensation per employee in Portugal has grown below productivity, leading to a gradual decrease in the wage share of aggregate income (in spite of an increase in total employment during the period). While this was insufficient to solve the problem of the Portuguese trade deficit with regard to EU, the source of that problem seems to reside less on the excessive wage growth in Portugal than to an insufficient wage growth in the center.
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The Portuguese adjustment program and its shortcomings

With a record of dismal GDP growth since 2000, a rapid increase in public debt after 2008 (as a result of the international crisis and the counter-cyclical measures undertaken in line with the European Economic Recovery Plan), and high levels of indebtedness of both firms and families, the Portuguese economy was particular vulnerable to the speculative attacks against sovereign bonds in the euro zone, which started in late 2009. Following Greece in early 2010 and Ireland later that year, Portugal submitted a request for financial help to the European Financial Stability Facility (EFSF) in April 2011. The Memorandum of Understanding between the Portuguese Government and the troika composed by the European Commission, the European Central Bank and the International Monetary Fund – which fixed the terms of the adjustment program that would accompany the EFSF's loan – fixed as main objectives the rebalancing of Portuguese public finances (by reducing public deficit from 9,8% of the GDP in 2010 to under 3% in 2013) and the adoption of a number of measures to strengthen the competitiveness of the Portuguese economy.

In general, the adjustment program that is being implemented in Portugal since May 2011 does not represent a dramatic break with the recent past with regard to the measures related with public finances. As was partly mentioned before, several policy initiatives in this field have been adopted in previous years, including: reducing the number of civil servants and their real wages; reducing the number of public agencies and managers; cutting back social expenditures (*e.g.*, by fixing an upper limit to non-contributive social benefits, eliminating special pension arrangements for specific groups of civil servants, changing the rules of unemployment allowances, fixing limits to expenditures within the national healthcare system, or introducing the means-testing principle in a wide set of non-contributive social benefits); downsizing public investment programs; privatising state-owned firms (continuing a trend that has been present in virtually every year in the last two decades); decreasing tax benefits for household expenditures with education and healthcare; decreasing tax benefits for higher pensions; increasing the VAT rate (now at 23%); increasing the maximum marginal rate in personal income tax (now at 45%); introducing a new tax on stock market capital gains; extending the base of social security contributions to previously excluded forms of compensation; among others. Concerning these domains, the Portuguese adjustment program essentially emphasises the need to proceed with the implementation of the measures already in place and, in some cases, to reinforce some of them (for example, imposing stricter limits to social benefits, greater cuts in public investment, and a stricter control of the budgetary process at all levels – central and local administration, quasi-public agencies and state-owned firms).

From adjustment to contraction

As expected, such austerity measures will lead to a steep decrease in economic activity and employment. For 2012, the Portuguese government expects a drop in GDP of 2,8% (after -1,8% in 2011) and an increase in the unemployment rate of 13,4% (more recent forecasts by the OECD and the European Commission are even drearier). Underlying the drop in GDP are: the strongest decrease in private consumption in recent decades (-4,8%); a substantial drop in public consumption (-6,2%); and an even more pronounced reduction in investment (-9,5%), after three consecutive years of negative growth and a decade of nearly paralysis in investment activity.

The contractionary implications of the adjustment program, in the context of a decelerating European economy (largely due to the austerity programs

The shortcomings of such deflationary approach to economic recovery in the present context can hardly go without notice.

being adopted in other EU countries), have already led to the need to adopt new measures in the fiscal area – the most relevant of which was a cut of nearly 12% in civil servants' wages (adding to an average cut of 5% that had been previously decided). The fact that the government had to introduce an additional, and substantial, cut of civil servants wages is not only a sign that the recessive impact of the austerity measures is greater than initially expected – it also suggests that the possibility to obtain significant improvements of the budgetary situation by cutting down superfluous expenditures, or by increasing revenues from unexplored sources, is entering into rapid decreasing returns.

In other words, given the measures that were already in place (some of which for several years), the Portuguese adjustment program seems to be mostly about forcing the reduction of the public deficit in the short term (in order to meet the goals set at the EU level), rather than radically changing fiscal management practices in the country. The aim to achieve a drastic reduction of the deficit is leading to a deep recession, which makes it even more difficult to achieve the desired goals in the fiscal front.

The capacity to achieve the deficit targets seems now to depend on a rapid return of the Portuguese economy to a growth trajectory. This, however, at the present juncture appears to be ever more distant. The adjustment program does not include any significant measures to counter the recessionary implications of expenditure cuts and tax increases. During the adjustment period all sources of growth are expected to come from net exports – and several elements of the adjustment program address the need to improve the competitive performance of the Portuguese economy.

The adjustment program's underlying strategy to improve the competitiveness of Portuguese exports emphasises two dimensions: product market regulation and labour market legislation.
In what concerns the former, Portugal has a generally positive record in complying with EU's competition laws and European Commission's recommendations. Still, the relatively high prices in some regulated markets (notably, the energy markets, which were highly intervened, partly as a result of the renewable energies' policy) signal that there may be room for increasing competitiveness by improving regulation.

Difficult changes to labour laws
Notwithstanding, most efforts in the realm of the so-called 'structural reforms' have been directed towards the labour market legislation. Among the first measures adopted under the adjustment program were the reduction in the maximum duration of unemployment benefit (form 36 to 18 months), and the substantial cut in severance payments in case of worker dismissal (from 30 to 10 days per year of tenure). More recently, the normal weekly working hours in the private sector were increased from 40 to 42,5. Together with the steep increase in unemployment, these (and possible future) changes in the labour market legislation are expected to improve the cost competitiveness of the Portuguese economy, by fostering a substantial drop in real wages.

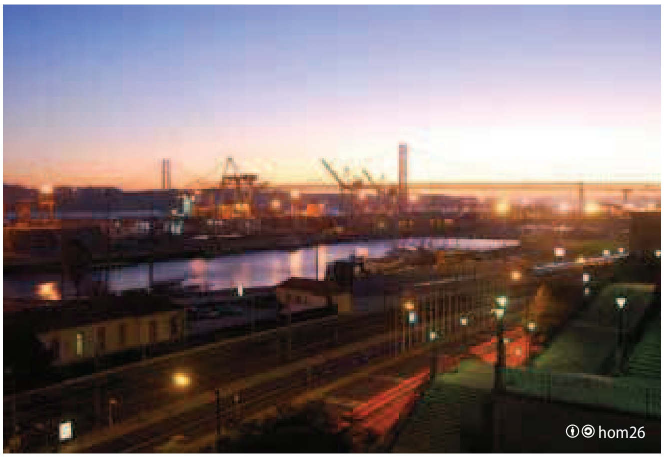
The shortcomings of such deflationary approach to economic recovery in the present context can hardly go without notice. First, and most obvious, the idea of putting all the weight of demand on net exports is now facing the dreary prospects of low growth in EU economies (which account for nearly ¾ of Portuguese exports); these prospects will tend to aggravate as most countries adopt austerity as the strategy to regain competitiveness – leaving very few outlets for any country's exports. Second, even if the international conditions were more favourable, the increase in net exports would have to be rather impressive in order to compensate for the drop in internal demand (which accounts for about ¾ of Portuguese GDP). Third, a substantial increase in exports would require huge investments by exporting firms – and this faces the hurdles of high indebtedness and severe constraints in access to credit by Portuguese firms under the present conditions. Fourth, for the increase in exports to have a significant impact, real wages would have to be cut down even further (a nominal drop of 30% to 40% is often pointed out as a requirement for rebalancing the current account, other things being equal), which means that the internal recession would be even more severe. Fifth, while tax increases and social benefits have been designed in order to mitigate the negative impacts on families in the lowest income groups, poverty and social inequality are expected to increase significantly – this in a country that has already one of the worse performances among developed countries in these domains. An even sharper approach to internal devaluation faces the risks of major social and political disruptions, which could jeopardise the efforts being made in the fiscal front. Finally, even if one takes for granted that some of the "structural reforms" included in the adjustment program may have a positive impact in the competitive performance of Portuguese exports (*e.g.*, better regulation of product markets, improvements in the budgetary process, greater flexibility in the labour market), it is hard to miss the fact that the program leaves largely untouched – and, to some extent, it contributes to worsen – some of the most relevant structural weaknesses of the Portuguese economy (which were discussed in section 2).

Adjustments undermining competitiveness

In fact, by cutting expenditures in education and social assistance the adjustment program will almost unavoidably make the fight against early school dropouts (in which important successes were obtained in recent years) even harder. With regard to the specialisation profile of the Portuguese economy (which, as we have seen, has been a core reason behind slow economic growth in the last decade), while the adjustment program may foster a greater weight of tradable activities (due both to the shrinking of the domestic market and to greater competition in regulated industries), the strong squeeze in real wages constitutes an incentive for firms to seek competitiveness through low labour costs, instead of searching for more advanced productive assets. Finally, the postponement of investments in important transport infrastructures (namely, with the aim of expanding the capacity of international airports and improving railway connections with the main European markets) will not help to curb the competitive weakness related to Portugal's geographic position.

Conclusion: sustainable ways out of the crisis
Summit after summit, EU leaders show an unconditional adherence to the view that the current crisis in euro area has its roots on the lack of fiscal discipline, especially among the peripheral countries. Because institutions and policy practices are never perfect, and given that anecdotal evidence of serious misconduct by national governments abound, such dominant view has been hard to contradict. In this context it becomes easier to gather wide acceptance around the notion that the solution to the crisis lies at reinforcing fiscal discipline at the continental level.

However, any serious attempt to identify the origins of the current crisis should go beyond such simplistic approaches. While it is not possible to exclude misconduct by successive governments from the list of factors that led to the Portuguese sovereign debt crisis, ignoring the role of a combination of structural weakness of the Portuguese economy and society with a sequence of external shocks – largely induced by EU level institutions and decisions – would be either patently misplaced. What is worse, the policy remedies that logically follow from such simplistic view risk missing some of the most relevant obstacles that have to be overcome in order to bring the European economies and societies back to a sustainable path.



In fact, this paper tried to show that most of the measures included in the Portuguese adjustment program were already in place before the market costs of financing became unbearable. In other words, contrarily to what is often believed, Portugal has been following closely (and with considerable success) several elements of the reform agenda that has become nearly consensual among the EC, the OECD or the IMF; notwithstanding, its economic and social outlook for the coming years is rather gloomy. In an international context characterised by persisting troubles in financial markets and slow growth, Portugal's commitment to bring down the public deficit to 3% of the GDP by 2013 will have to be achieved through additional tax increases, severe cuts in civil servants' wages, and substantial cuts in social expenditures. Beyond the social problems and the political instability it fosters, this strongly pro-cyclical fiscal strategy risks being self-defeating due to strongly negative impacts of fiscal austerity on public finances.

In other words, austerity risks destroying the basic pillars of a decent society, while having, at best, indeterminate impacts on fiscal balances.

It would be unfair to suggest that the Portuguese adjustment program does not go beyond imposing a highly pro-cyclical approach to fiscal management, the consequences and risks of which – social, political and economic – are too evident. In fact, the program is expected to foster reforms that should help to improve the performance of the Portuguese economy in the future, such as a stricter control of the budgetary process or a better regulation of some product markets. However, the analysis of the program – and conjunction with that of the decisions being taken at the EU level – leads to the conclusion that reducing the labour costs constitutes the core ingredient of the underlying strategy to overcome the current crisis.

As we have seen, the changes in the labour market included in the adjustment program (namely reducing the costs and conditions for dismissals, as well as the duration and the amounts of unemployment benefits) together with the increasing rates of unemployment (largely related to fiscal austerity), are expected to result in decreasing unit labour costs, which are expected to improve the price-competitiveness of the Portuguese economy.

However, as an increasing number of EU countries revert to austerity – and, in many cases, to the same type of policies targeting reduction in the labour costs – the success of such a strategy, in terms of economic growth and fiscal sustainability, becomes less certain. On the contrary, the impacts of such strategy on the erosion of public services (health, education, social assistance, etc.) and the increase in inequality (with the continued reduction in the wage share of income and the increase in poverty rates) are hardly avoidable. In other words, austerity risks destroying the basic pillars of a decent society, while having, at best, indeterminate impacts on fiscal balances.

More importantly, by demanding a substantial cut in public investment (after years of negative growth in this variable), the adjustment program will jeopardise the efforts that have been made in recent years in order to ameliorate some of the most obstructive weaknesses for the development of the Portuguese economy and society (such as low education levels, high poverty and inequality, low sophistication of the productive structure, and the peripheral position of the Portuguese territory).
In sum the EU is not merely facing a problem of lack of mechanisms to prevent the self-fulfilling prophecies of financial speculators or the need to reinforce fiscal discipline. The EU economies urgently need to return to a sustainable growth path (a *sine qua non* condition for solving the fiscal crisis), as well as to find ways to deal with differences in economic and social structures among Member States (that lie at the roots of the current crisis).

There is room for institutional reforms at the EU level that would reduce the risks of financial instability, support economic recovery, and promote growth and social justice, without jeopardising the need for sustainable public finances. Such reforms at the EU level include: coordination of wage setting, budgetary rules which are able to accommodate asymmetric developments in business cycles, corporate tax harmonisation, and the introduction of financial instruments that help to prevent speculative attacks on sovereign debt of member states.

In the short run, the EU should adopt a strategy that would match the call for a greater control of fiscal management with the need to re-launch economic growth through intelligent investment. For example, excluding national co-financing of EU Cohesion Policy from fiscal targets, conditional to the strict alignment with Europe 2020 strategy, would: (1) contribute to a counter-cyclical response to economic slowdown and social crisis; (2) foster investments that would help to address structural weaknesses of the EU's periphery, making them more competitive and, simultaneously, promoting a sustainable path to economic growth (*e.g.*, investments in energy efficiency, trans-European transport networks, electric mobility); and (3) assure that adequate mechanisms for policy monitoring and evaluation would be in place, in order to maximise the impacts of public interventions on sustainable development, while minimising the misuse of public resources.

Without going beyond the austerity route, the EU economy will be condemned to a prolonged period of slow growth, high unemployment, growing inequality, gradual destruction of the welfare state, and the recurrent postponement of the investments that are necessary to promote sustainable development and to overcome the most relevant structural sources of lack of competitiveness in some peripheral countries – leaving largely untouched the factors that led to the current crisis

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