GLU

Global Labour Column
http://column.global-labour-university.org/

Number 193, February 2015

CSID
CORPORATE STRATEGY AND
INDUSTRIAL DEVELOPMENT

Trouble ahead in Portugal, still?

by Ricardo Paes Mamede

Clean exit?

A 'clean exit'. These were the words used last May, at home and abroad, to celebrate the end of the Portuguese three-year adjustment programme, just like in Ireland a few months earlier. Having accumulated a buffer that covers government financial needs until the end of 2015, Portuguese authorities announced, just ahead of the elections to the European Parliament, that the country would not need to resort again to international assistance – whether in the form of a precautionary line by the European Stability Mechanism, or a new loan by international creditors.

The 'Portuguese exit' added to the general sense of relief that has been increasingly felt among EU authorities since the European Central Bank (ECB) announced the Outright Monetary Transactions (OMT) programme in 2012. The continuous drop in government bonds' interest rates across the Eurozone is seen as a decisive step to overcome the risks of disruption in the European Monetary Union. Though acknowledging the high social and economic costs accruing from several years of budgetary austerity, EU official documents typically conclude that the adjustment programmes implemented in the periphery of the Eurozone were essentially successful, having created the conditions for a sustained recovery from of the crisis.

In dire straights

However, a closer look at the macroeconomic data suggests that caution is warranted. According to official figures, by the end of 2014 Portuguese public debt will amount to 127% of GDP. With the current, relatively low levels of interest rates (3.4%, on average), this means that the government is paying nearly 4.5% of GDP in interest each year, mostly to foreign creditors. The mid-term forecasts for Portugal assume that the growth of domestic demand in the coming years will be strongly hampered by very high levels of private and public indebtedness, as well as by the ongoing concerns with budgetary consolidation (OECD, 2014). Net exports, in turn, are expected to grow modestly, reflecting GDP growth at the European level. The question therefore is: can Portugal plausibly be expected to fulfil its obligations towards its creditors, while complying with the EU budgetary rules?

In order to answer this question, I start by assuming a moderately optimistic outlook for the Portuguese economy in the mid-term. Suppose real GDP growth would soon return to its long-run trend of 1.8%, while inflation, measured through the GDP deflator, would also rise to 1.8% (these values correspond to the mid-term forecasts presented by the Portuguese government earlier this year). Assume, as well, that the average interest rates on Portuguese public debt will remain around 3.4%. Starting from the aforementioned levels of public debt, my estimates are that Portugal, in order to comply with EU fiscal rules, would have to run primary budget surpluses systematically above 1% for nearly a decade[1].

Now, while this requirement may sound reasonable, historical experience seems to suggest otherwise. This can be seen by looking at data on EU countries since the mid -1990s. The information available for this purpose in the European Commission's AMECO database allows following the 28 EU Member States for over 18 years (1996 to 2013); that is, we have 18x28=504 observations for the whole period. Then we ask: how many times did a country generate a budget surplus of at least 1% of GDP in a given year, in a context characterized by moderate annual real GDP growth (i.e., no more than 1.8%) and a moderate inflation rate (i.e., no more than 1.8%)? The answer is 19 times, or 3.8% of the observations.

In other words, in order to comply with its external obligations, Portugal would have to achieve for several years a combination of characteristics that were rarely seen, not only in Portugal, but in *any* European country, in Europe in recent decades.

It therefore seems very unlikely that Portugal will be able to fulfil its obligations towards its creditors, while complying with EU budgetary rules – unless the Portuguese government decides to enforce a radical transformation of the Portuguese economy and society, with potentially dramatic consequences.

Another triangle of impossibilities

I have called the situation that Portugal faces at present the *Triangle of Impossibility in Budgetary Policy*[2] – inspired by the trilemma made popular in macroeconomics by Obstfeld and Taylor (1997). Imagine a triangle with the following vertices: the first is the full payment of the Portuguese public debt according to the prevailing in-

University of the Witwatersrand

Nicolas Pons-Vignon, E-mail: Nicolas.Pons-Vignon@wits.ac.za
Mbuso Nkosi, E-mail: Mbuso.Nkosi@global-labour-university.org

terest rates and maturities; the second is compliance with EU budgetary rules; and the third corresponds to the preservation of minimum standards in the Welfare State. The Triangle of Impossibility suggests that, given the current conditions, it is not possible for Portugal to fulfil all three conditions at the same time.

Thus, in order to comply with the EU's budgetary rules in the absence of debt restructuring, Portugal would have to implement significant cuts in education, health and social protection budgets, and tax increases over and above those that were implemented in the past four years[3]. Alternatively, if the country is to preserve minimum levels of Welfare State, it must either restructure its debt and/or postpone compliance with EU budgetary rules.

Recent declarations by the President of the European Commission, Jean-Claude Juncker, regarding the need for more flexible budgetary rules in the EU and for an EU-wide investment programme, have given some hope that the current hurdles could be addressed without having to fall into the type of trilemma described above. However, according to my estimates, the tensions underlying the *Triangle of Impossibility in Budgetary Policy* remain essentially unchanged in a context of slightly more lenient budgetary rules (such as imposing a maximum of 3% of GDP for the nominal deficit, while dropping the requirements regarding the structural deficit and public debt). Moreover, we have seen that the *Triangle* is based on GDP growth forecasts that are already rather optimistic, given the current state of the Portuguese and the European economies.

Structural problems require more than structural reforms

The problems faced by the Portuguese economy – and by other economies at the periphery of the Eurozone – are now well-known (Teixeira, Silva and Mamede, 2014). At a structural level, they result from the combination of high levels of private and public indebtedness with weak profiles of specialization (i.e., overspecialization in low value-added industries, which are highly exposed to competition from low-income countries), which together constitute a significant obstacle to future growth. At a cyclical level, these countries face the difficult task of dealing simultaneously with internal and external imbalances, while being deprived of several key economic policy instruments (whether monetary or fiscal).

So far, the solutions found to deal with these challenges at the EU level have been insufficient to sustain optimistic views regarding the future. When the buffer built to deal with financial needs will be exhausted by the end of 2015 (which should happen soon after the next general elections, due in October), the Portuguese government will be facing the need to reimburse nearly €100 billion of debt until 2021. By then it will be clearer that trouble is still hovering over Portugal. The need for a combination of debt restructuring, budgetary flexibility, and public investment will ultimately become self-evident.

1 These estimates are based on the commonly used debt dynamics equation as presented for instance in De Grauwe (2012)

2 (http://ladroesdebicicletas.blogspot.pt/2014/05/o-triangulo-das-impossibilidades-da.html)

3 The measures of the Portuguese adjustment programme include: reducing the number of civil servants and their real wages; fixing an upper limit to non-contributive social benefits; reducing the duration and amount of unemployment allowances; limiting expenditure within the national healthcare system; reducing the education budget; increasing income tax rates; decreasing tax benefits for household expenditures in education and healthcare; decreasing tax benefits for higher pensions; increasing the VAT rate (now at 23%). Many of these measures have been in place for almost a decade – see Mamede (2012) and Abreu et al. (2013).

Ricardo Paes Mamede is a Professor of Political Economy at ISCTE – Lisbon University Institute and holds a PhD in Economics from Bocconi University (Italy). He was head of department for economic analysis and policy evaluation at two government agencies in Portugal. In 2014 he coedited (with Aurora Teixeira and Ester Silva) the book *Structural Change, Competitiveness and Industrial Policy: Painful Lessons from the European Periphery* (Routledge).

References

Abreu, A; Mendes, H.; Rodrigues, J.; Gusmão, J.; Serra, N.; Teles, N.; Alves, P.D.; Mamede, R. (2013), *A Crise, a Troika e as Alternativas Urgentes*, Lisboa: Tinta da China.

De Grauwe, P. (2012), *Economics of monetary union* (9th edition), Oxford University Press.

Mamede, R. (2012), "Causes, consequences, and ways out of the crisis: a perspective from EU's periphery", Green European Journal 1, pp. 30-46.

OECD (2014), *Economic Survey of Portugal 2014*, Paris: OECD.

Obstfeld, M., & Taylor, A. M. (1997), "The great depression as a watershed: international capital mobility over the long run", *NBER Working Paper No. 5960*, National Bureau of Economic Research.

Teixeira, A.; Silva, E.; Mamede, R. (Eds.) (2014), *Structural Change, Competitiveness and Industrial Policy: Painful Lessons from the European Periphery*, London: Routledge.