

An essay on the evolution of economic, social and European policies in Portugal

January 2011, José Albino da Silva Peneda

The situation that Portugal has reached can be overcome. To achieve this one must understand its origins and learn from past mistakes and policies need to be modified. Portuguese political leaders should also be more active in the decision-making centres of the European Union and the euro area and seek aiming at shaping guidelines that will highly influence our collective future. However, those goals must be pursued without devaluating labour, reducing wages or dismantling our welfare state. Through the right choices based on discipline, more savings from households and businesses, a controlled budget and proper investment, Portugal can beat the crisis.

This essay is a modest contribution to the discussion about those goals and the path to achieve greater economic growth and more social equity.

The current crisis has one thing in common with past ones which is the country's excessive debt that has resulted from the idea that a stronger state role, redistribution of income and budget and wage policies was enough to ensure a better life.

This idea led to the International Monetary Fund (IMF) intervention in our country in 1978 and 1983. Compared to that time, the only new aspect of the current crisis is that Portugal belongs to the single currency's club and therefore, when it comes to the measures that can be applied, the country's manoeuvre margin is much smaller than in 1978 and 1983.

As for the current crisis two issues should be demystified. The first one is that its origin relies exclusively on a planetary scale but that is not true. The main determinant factors of the situation are national and European. The second one is that everything happened suddenly and without warning which is also not true.

1. The origin of the crisis is not exclusively worldwide

At national level we must recognize that wrong policies were adopted in crucial moments.

In the second half of the 1990 decade, and during the first years after the adoption of the euro, Portugal registered economic, low interest rates and a credit rise. This situation led to a strong increase in consumption which resulted in higher household and corporate deb. In this scenario, fiscal policy should have become more restrictive. However, Portugal pursued an expansionist budget policy which translated into an import increase and high imbalances in

the country's current account. The country was not able to implement structural reforms that could have strengthened domestic supply and to aggravate the consequences of this failure, a weak productivity growth led to losses in competitiveness.

Before Portugal joined the euro area, there was also an increase in public spending nevertheless, at that time, that increase was more than offset by strong economic growth. On the other hand, in the second half of the 1990 decade it was a strong decrease of interest rates - from 13% to 4% - that mainly contributed to lower the government's bill and lessened the increase in public spending.

2. The country's situation should not be considered a surprise

Unlike what many say, the situation the country has reached should not be considered a surprise. The Economic and Social Council of Portugal, for instance, had already made recommendations in 2000, 2002 and 2007 that made warnings about the future:

"The increase of exports is crucial not only for the GDP's growth but also to cushion the rising external debt that the country has been experiencing for several years. If this increase remains it may seriously threaten the future growth of the national economy despite easier external financing that the entry of Portugal in the euro area has created". (Opinion on the "Plan's Main Options"¹, 2000, page 12).

"The modernization process is being done neither with the pace nor with the depth that would be desirable and it is generally recognized that the rhythm of structural changes in the Portuguese economy in the last decade has not been appropriate." (Opinion on the "Plan's Main Options"², 2002, page 72)

"The Council sees with great concern (...) that the low economic growth is accompanied by increased external deficits that have reached unsustainable levels given its rampant growth pace since 1996". (Opinion on the "Plan's Main Options"³, 2007, page 9).

The current crisis differs from previous ones in one aspect only which is the fact that nowadays Portugal belongs to the euro area and therefore currency devaluations, which was the privileged corrective mechanism before, is no longer a feasible one. However, the causes of the crisis are similar: increased domestic demand fed by government spending, excessive expansion of credit to households and increased external debt. Previous crisis were overcome through currency devaluation, which led to a decrease in real wages, nevertheless that approach have never achieved the fundamental which would be to increase productive investment with productivity gains. Due to uncertainty

¹ Parecer sobre as "Grandes Opções do Plano", 2000.

² Parecer sobre as "Grandes Opções do Plano", 2002.

³ Parecer sobre as "Grandes Opções do Plano", 2007.

regarding financing facilities, aggravated by unfavourable exchange rate and monetary policy instability, financial speculation has become more interesting than productive investment.

3. A new approach for the economy and employment fostering

High levels of employment with, as far as possible, controlled insecurity, are the only recipe to safely guarantee economic welfare and social balance. Additionally, the state has the means to ensure the protection in adverse life situations: illness, unemployment, old age, disability and death. Therefore, we can only talk about exiting the crisis when unemployment is reduced significantly. One can analyse three approaches which, alone, are not able to guarantee such reduction.

Firstly, Portugal cannot exit the crisis on the basis of policies that lead to a sharp reduction in domestic demand on the assumption that this would reduce imports and, thereby, the external deficit. This path, which is proposed by the European Commission and embodies the usual approach of the IMF, would have a brutal effect on unemployment. Prof. João Ferreira do Amaral has said *"if domestic demand declined by 1% over the next five years, unemployment rate would increase, to at least, 17% at the end of those five years ... additional and deep cuts on domestic demand in the current situation are quite irresponsible"*.

On the other hand, wage reduction will not guarantee competitiveness gains for our economy. If this approach is pursued, the reduction effects of domestic demand will also be felt. This would lead to an increase of problems for indebted households and a deflation process could start which would be devastating for the economy. In the last decade, wages were not the main factor responsible for the loss of competitiveness. In fact, wage evolution has been moderate as shown by the broadly unchanged proportion of wage income in terms of GDP, similar to the euro area average.

Firstly, the current labour law has been revised recently based on a large consensus and not all its possibilities have been fully exploited namely in what conveys collective bargaining or negotiations at company level. Secondly, it does not seem recommendable to make frequent changes in those matters because of the time needed for their implementation and for the production of jurisprudence. Thirdly, the current labour law contains flexibility tools which are more than enough to adapt work organization to market needs. Fourthly, job creation cannot be achieved by legislation. Fifthly, imbalances between workers with open-end contracts and those with fixed-term ones can only be solved if the economy grows in a way that entrepreneurs will want to retain workers in their companies.

The path that allows exiting the crisis with job creation will have to be based on a new orientation of economic policy, which main principle will be to place capital at the service of those who create wealth and jobs. This means

supporting production of tradable goods and requires unlike the practice of past years which has led the country to generalised deindustrialization which rate was among the highest ones in the world. With this approach we would be able to increase exports and decrease imports, with job creation. This would translate the idea that the rebalancing of public finances and economic growth are not incompatible goals. In this sense, together with the fiscal consolidation, which could be fairer than the one which is taking place, we would see a positive discrimination aimed at supporting the sectors of tradable goods.

This new economic policy would combine three important goals simultaneously. Firstly, it would lead to a reversal in the rate of accumulation of external debt; secondly it would foster domestic demand, and thirdly, it would encourage the creation of jobs.

Such measures could include the reduction of corporate taxes, fostering investment through tax incentives in the sectors mentioned above, creating a simplified regulatory framework for those activities, namely agriculture, decreasing corporate contributions for their workers' social security which could depend on the company's added value as well as the creation of a special system for loans facilities in the country's public bank (Caixa Geral de Depósitos).

This new economic policy would give a particular role to the combat of the parallel economy. According to a study recently released by the Faculty of Economics of the University of Porto, the trade volume in the underground economy is around 40 billion Euros, equivalent to 24.5% of the national GDP. If this figure was taxed at 20% (around 8 billion Euros) the public deficit would be less than 3% of the GDP! Those figures reflect the extent of the problem and no matter how little can be done in this area the results shall be very positive.

Aiming at decreasing unemployment, the promotion of active employment policies is essential. The permanent monitoring of the employment market, a more effective functioning of the public employment services and a differentiated application of measures according to the regional reality are some aspects that can also be analyzed based on social dialogue.

4. The Importance of a structured social dialogue

The Portuguese society today is very different from the one of the past. It is more diverse, mobile, complex and fragmented. It also incorporates new forms of organization that put pressure on governments so that the political decision-making includes new participants. The response to this trend can only be given on the basis of a structured **social** dialogue.

Another characteristic of modern times is the growing importance of interdependencies whether at a financial, economic or market level. Those interdependences between everything and everyone make decision-making processes more complex as they, increasingly, have to take into account

different interests sometimes antagonistic. A proper perception of risk associated with decision-making requires a good understanding of the motivations of those involved and this can only be achieved on the basis of a structured **social** dialogue.

Nowadays governments must monitor and anticipate the interests of several different groups in society. A reactive approach has resulted in inadequate and delayed responses as at the time of the response the range of solutions is already very low. A greater ability to predict the aspirations of society requires the adoption of a proactive strategy to engage public authorities and economic and social agents. That perception can only be achieved on the basis of a structured **social** dialogue.

Finally, it is increasingly clear that the values associated with freedom, democracy and human rights are not limited to elections. In our time, the road to peace and prosperity requires the continued development of a culture of commitment based on the responsibility of each party.

Those are some of the arguments based on the characteristics of the society of our time, which may explain the virtues of structured social dialogue that can engage all stakeholders involved in the design and implementation of economic and social policies. In the framework of the current crisis this belief is reinforced as the problems we face are not compatible either with simplistic methods or unilateral actions.

For all these reasons, the practice of structured social dialogue is a method that should be privileged. This vision of modernity requires the different political forces and economic and social agents to differentiate the important from the accessory in their daily activities. This will be the only attitude that can contribute for the achievement of the most important goal: economic growth at a pace that can significantly reduce unemployment. In this context, political parties and social partners play a fundamental role in the parliament and in collective bargaining, respectively.

Aiming at an effective action from social partners, in a complex social consultation exercise, a set of fundamental assumptions must be defined and accepted so that the country does not make past mistakes.

The first lesson to draw from the recent past is that the era of neo-liberal experiment has failed and the market's self-regulation is a theory without any grip on reality because, as demonstrated recently, the market is not able to self regulate. Hence, government intervention is crucial to overcome the situation that the country has reached.

The second lesson stems from the excessive role played by the financial sector in recent times. The financial system needs restructuring, more transparency and should serve the real economy. Mere speculation should be penalized and productive investment encouraged. Those who speculate financially should be penalized and those who create wealth and jobs supported.

The third lesson to be learned from the past is that the economy has to be constantly scrutinized, audited and evaluated so that it can be understood by most citizens.

The fourth lesson is that both governments and opposition parties, especially those which could emerge as an alternative, should ban the utopia and unlikely promises from their speeches. Such practices only lead to disillusionment and steal the hope for better days. Only the truth and reality may foster hope. People accept better concrete change in their lives rather than optimistic but unreal dossiers.

The fifth lesson is that commitments and agreements between the government and other partners must not be broken. The recent violation of the agreement achieved by social partners with regard to pension reforms that was broken unilaterally is one example. Such attitudes have necessarily negative consequences because they undermine the mutual trust of the parties involved.

5. A more proactive European Policy

Considering the influence that European policies have on the economy and the lives of Portuguese citizens they are poorly discussed at national level.

It is worth noting the recent past of the euro area, the possible evolution scenarios and the strategic direction which would suit our country best.

At European level there have been forecast errors, supervision failures, absence of corrective mechanisms and institutions have been too slow in the response to emergencies. Those facts have also contributed to the situation that our country has reached.

The euro's first decade has been very successful. There were 11 countries in the euro area 10 years ago, there are now 17, and several other countries are potential candidates. The euro has rapidly become a stable currency and it is now the world's second reserve currency. The euro has guaranteed price stability and, if it did not exist, several countries in the euro area would have experienced serious foreign exchange crisis in the complex economic and financial environment in which we find ourselves. The euro has indeed been an excellent protective shield, particularly for the most vulnerable countries such as Portugal.

The euro was introduced against the theory of economic integration which says that a single currency only emerges when there is a single market, which in turn arises out of the integration of the markets of its various component countries. According to the theory, this market will generate a single currency, a more federal fiscal policy, etc. However, this has not been the case with the euro which emerged without a single market. The truth is that the European single market does not fully exist, as will be explained below. The euro, like many other aspects of European integration, is therefore yet another unique case.

While the European single currency has been a genuine success in its first decade, the question now is what its teenage years will be like. While the euro's 10 years of life have undoubtedly had positive aspects, I suggest that we make an effort to look at the other side of the coin. The currency's greatest weakness is that the economies of the euro area are not growing or are growing very slow. If they are not expanding, they cannot successfully play their role which is to be highly competitive at global level. If the euro area loses influence in terms of competitiveness compared to other regions of the world it will be useless to praise the noble values that underpin the European project, social Europe and many good intentions of the people that see the project of European integration as an opportunity to institutionalise the civilised values that have created what is more human, free and fair in earth.

The collapse of the euro would lead to the dismemberment of the whole political project of European integration, with tragic consequences for the continent and for Portugal.

I will set out two main causes for the euro area's weak economic growth.

Firstly, a single currency exists but there is no European economic system, no European financial system, and not even adequate links between Member State's economic and financial systems.

Concerning the non-existence or weakness of the European economic system, the truth is that each Member State still protects its own strategic sectors. The United Kingdom protects its financial services, Germany looks after its equipment industry, which is expanding eastwards, and Scandinavia strives to protect its niche of new technologies. There is no European economic system.

There is lack of synergies between national economic systems. We do not have truly European enterprises. What we do have are national enterprises which are becoming European and getting globalised.

As it has evolved to date, the single market offers many advantages, primarily because it has enabled many enterprises to grow stronger as they have benefited from a larger, more integrated and more competitive market. On the other hand, rather than reinforcing specialisation, the single market has instead reduced it, precisely due to strong competition within each sector, an effect that will be very significant in the context of increasing globalisation.

As far as the financial system is concerned – perhaps the most sensitive issue – the European Union as such is unable to intervene. The EU is unable to intervene because its Member States have kept the financial system segmented. And to make matters worse it has to be said that, as the recent financial crisis has demonstrated, transparency in those markets is far from ideal. It seems that the financial services action plan set up in 1999 by Commissioner Mario Monti, which incorporated legislative measures to pave the way for the emergence of a true and genuine European financial services market, has fallen by the wayside.

It must be accepted that financial integration is taking place everywhere, not only in the EU, but the trend is also to speed up the pace of globalisation. If the EU wishes to be in a position to influence this process at global level it must put its "house in order". Despite recent developments, a great effort is still to be done to regulate financial supervision at EU level. This is one case where efforts at national level do not make sense and where transparency is needed.

Without controlling the main financial levers at European level, there will never be a European economic policy, a European industrial policy, or European enterprises, much less a European single market.

Secondly, the euro is not linked to a macroeconomic policy. In the euro area there is no coherence between budgetary and monetary policy. Coordination between monetary, budgetary, fiscal and other policies is also very poor. Anti-cyclical policies, meanwhile, do not exist, which is clearly detrimental to innovation and economic growth. SMEs, for which financial conditions are critical, particularly when they have to pay off loans in times of weak economic activity, are a good example.

If it is seen as advantageous to have a European macroeconomic policy, there also needs to be a proper EU budget, to which Member States' maximum contribution has remained at 1.24% in the last two decades. Meanwhile, however, the EU has ratified three treaties, undergone three enlargements and taken on much more responsibility. Just as important as this aspect is the fact that it is not possible to make much more progress with the current method of drawing up the Community budget. The obstacle is that 85% of the EU's financial resources are currently not genuinely own resources, since they originate from Member States' national budgets.

The two largest sources of revenue, VAT and national contributions based on Gross National Income (GNI) are collected by national treasuries and sometimes presented as an expenditure item in national budgets. Member States tend to judge EU policies and initiatives more in terms of a return on investment compared to national contributions, rather than analysing such expenditure from a global perspective, taking account the value of policies implemented at European level.

A new form of own resource will therefore have to be conceived and it should avoid the disadvantages of the current system, which has no direct link to citizens, is heavily dependent on contributions from national treasuries and is unnecessarily complex.

Reforming the EU budget is not an exclusively financial matter, but is a far-reaching and essentially a political issue. It cannot therefore be discussed solely in the European Parliament, in the Council and much less in the ECOFIN. If this reform is to be successful, it is vital that not only European but also national stakeholders and political institutions, namely national parliaments, are involved throughout the whole process.

The euro area economic growth will not be high in the near future, but more worrying is the fact that some Member States may go through years of recession, highlighting regional imbalances in the euro area. The result is the weakening of public finances in some countries. Against this background, there are a number of possible scenarios for the euro area.

In the first one, the financing difficulties facing the most indebted euro area countries could force their governments to take drastic measures to boost public finance, i.e. cuts in public spending and/or tax rises. This is the scenario that is already being experienced in our country and will be even strongly felt during 2011. This approach has the risk of exacerbating the recession which could prevent an improvement in the fiscal situation. The loss of competitiveness associated with a process of recession is an explosive cocktail. It is not a path that brings hope in better days and it may generate uncontrollable phenomena of social upheaval.

The second scenario would involve injecting money into the most vulnerable euro area Member States. This scenario has already happened in Greece and Ireland and it went together with restrictive conditions similar to the ones usually imposed by the International Monetary Fund. The European Financial Stabilisation Mechanism (EFSM) of 750 billion Euros, adopted by the European Council, has been the instrument used. What is certain is that in both cases we are dealing with therapeutic methods, and concerning the EFSM, Germany has already warned that this help can only be used as last resource which means when the patient is already in a deep coma.

The third scenario would lead to the existence of a single central issuer of public debt, and therefore greater political integration in the euro area, together with some form of 'fiscal federalism'. European debt would then have a single rating. Although from a theoretical perspective this is the scenario which is the most compatible with the euro sustainability, its achievement would require major political changes and stronger political integration in the euro area, accompanied by some form of "fiscal federalism". This is the scenario that most interests Portugal and actually proposed by the President of Euro Group, Jean Claude Juncker, together with the Italian Minister of Finance, Giulio Tremonti, in the eve of the European Council in December 2010. Given the negative reaction of Germany, and the assertive response from the president of the Euro Group who accused Germany of anti-European behaviour, the poorly visible positions of Portugal and Spain seem surprising.

The creation of euro bonds can not be interpreted as a facilitator of the lives of the ones that have not complied with the rules. The creation of euro bonds is the logical consequence of the political process that has led to the euro. The creation of euro bonds embodies the idea that the crisis in the euro area is a systemic one that can only be resolved through a systemic solution.

The creation of euro bonds requires more federalism in the development process of European integration. However, if on one hand strong economic and social imbalances can be expected if we follow that path on the other hand the alternative would be increased insecurity and uncertainty about the future.

Sometimes it seems that the main reason behind the creation of the European project has been forgotten and we should recall that the ultimate goal of this project was to create conditions for the existence of peace in a continent whose history is of conflicts and fratricidal strife between its people rather than with an external enemy.

The process of evolution of the euro area looks like crossing a river through a very weak bridge. So far only half of the river has been crossed and either we move forward towards the other side or the bridge will fall. Being stuck in the middle of the bridge is similar to the exclusive political goal of fiscal discipline. However, the truth is that fiscal policies, even if appropriate, are not enough to get to the other side. To reach the other side, long-term investment should be stimulated in strategic areas and the financial system should be in line with these options, through joint decisions.

To reach the other side, the EU needs to make strategic choices in other areas to compete in the World and Portugal has to be prepared for those negotiations namely in what concerns the energy policy that should ensure a secure supply and competitive prices; the industry through strategic specialisation and companies that bet on their potential growth beyond internal competitiveness; agriculture, which should be seen as a strategic sector in terms of security in food supply and in world trade; regulatory issues related to public goods such as water, climate, health and food which will lead to a reform of the World Trade Organization.

To reach the other side, Portugal should develop a strong diplomatic offensive, with the support from its natural allies, in order to convince European institutions and all States outside the euro area that rebalancing public finances and economic growth are not incompatible goals. Aiming at this it should be possible to set a system of positive discrimination for the most vulnerable European regions.