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Has Portugal Avoided the Fall?

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Becoming a member of the eurozone was an important milestone in the development of the Portuguese economy within the European Union. EMU-membership brought economic growth, monetary stability, decreasing inflation and falling interest rates for a short time. However, fulfilling the Maastricht criteria did not last long. In 2002 Portugal was the first to breach the rules of the Stability and Growth Pact and to become a subject of the Excessive Deficit Procedure (EDP). Between 2002 and 2004, the budget deficit was kept below 3 per cent of GDP. But for 2005 the deficit reached more than 6 per cent and was again followed by an EDP procedure. This worsened the country's reputation. The government continuously took measures to decrease the deficit, but did not make permanent adjustments to the budget. Therefore, as the crisis came and as a consequence of the anti-crisis measures, the public deficit soared to 9,4 per cent of GDP.

In the first half of 2010 the torments of the eurozone also reached Portugal. After Greece, the country was considered a possible next candidate for a "rescue package". The Portuguese government has been trying everything to defuse negative speculation and emphasize its differences from Greece, but Fitch Ratings, Standard and Poor's and Moody's Investors Service keep degrading the country's debt rating.

In the summer of 2010, trust in the Portuguese financial system was restored to a certain extent as all four of the big Portuguese banks (Caixa Geral de Depositos, Banco Comercial Portugues, Banco Espirito Santo and Banco Portugues de Investimento) achieved good results in European stress tests. Later on, however, as Ireland also "fell", financial market attacks against the Iberian country began anew.

Over the last two years, the main aim of the government has been to push down the public deficit (to 2,8% to 2013) and debt (82.8 percent of GDP last year), which, according to the European Commission, is forecast to increase to 88.8 per cent in 2011. Reducing the public deficit has been far from easy because the minority government is at the mercy of the parliamentary opposition for the approval of austerity measures. The last sharp debate was in November 2010, when the third harsh package was finally passed.

The international financial market continued to show distrust in Portugal in 2011. The economic atmosphere is still dominated by the debt crisis, nervous financial markets and internal political fights. The yield of Portuguese bonds increased to around 7 percent and analysts found it probable that, after Greece and Ireland. Portugal would also have to request a rescue package (the total size of which could be around 60-80 billion euros). The Portuguese government again rejected such claims and announced that it had managed to cut the public deficit even more than intended (7.3%) for 2010. This was the biggest cut in the entire eurozone. For the current government, the only chance is to resist a rescue. Otherwise Portugal will face a serious political crisis and the prime minister be forced to resign. The government has promised to continue its strict measures and to reduce the deficit to 4,6 per cent in 2011.

The European Central Bank took steps to support Portugal, and Japan and China indicated they would also buy bonds. As a result, the auction of Portuguese debt bonds on 12 January went relatively well and the market grew calm. Investor yields on bonds maturing in 2020 came in at 6.7 per cent. However, on bonds maturing in 2014, the yield jumped to 5.3 percent – up from the data in November – and suggesting greater concerns remain in the short-term. The government has so far raised €1.25 billion, but must raise €20 billion in fresh financing this year, and

must also succeed in covering another 26.5 billion euros in maturing debt.[1]

Thus Portugal has temporarily avoided the fall, but the question is whether this will be sustainable in the long run. A further question is whether other EU members (*e.g.* Germany) will support troubled periphery countries by, for example, approving the issue of EU-level E-bonds. Jean-Claude Juncker, the prime minister of Luxemburg, and Giulio Tremonti, Italian finance minister, suggested such a course in December 2010. According to them a European Debt Agency would have a mandate to "gradually" issue debt up to as much as 40 per cent of the GDP of the EU and each member state. The idea has so far been rejected by Germany, who continues to defend budgetary discipline.

If the periphery countries have to go it alone, the minority Portuguese government will face an extremely serious and difficult task. Continuous fiscal steps and restrictions mean a short –term solution and negatively impact internal demand and growth. On the second week of January 2011, the Portuguese National Bank published negatively revised projections, foreseeing a 1.3 per cent contraction of the GDP for this year. Portugal's fiscal policy has always been characterised by short term, pro-cyclical measures and the lack of transparency. Structural reforms have not been undertaken during EMU membership.[2]

Already during the present period of short-term consolidation, the foundation for long-term growth should be created. One part of a sustainable growth strategy could be *renewable energy*, an area in which Portugal has deliberately been focusing its efforts for some years. Sunny and windy coastline provides excellent opportunities and the exploitation of water, wind and solar energy[3] has helped to decrease Portugal's import-dependence and promote job creation. Currently 45% of electricity production already stems from renewable sources, compared to 17% only five years ago. Wind energy capacity was 537 MW in 2004. But by 2009 it was 3,450 MW. Capacity has continued to increase in 2010 by an additional thousand MW. According to the National Action Plan for Energy Efficiency the use of energy will likewise decrease by 10 per cent by 2015.[4]

Another pillar of the recovery may be a *rise in Portuguese exports*, mainly towards non-EU areas. Angola, for example, recently became Portugal's most important trade partner outside the EU. The cultural and language ties from colonial times have been utilised by more and more Portuguese companies. The strongly increasing African market is important for Portugal. Asia and Latin-America also represent important emerging markets. The Portuguese government further supports the internationalisation of companies and the expansion and diversification of exports in several ways.

The Portuguese labour market became more flexible over the last decade and labour force qualifications have increased. This is a factor from which further improvements in *education and research and development* may benefit. Several measures were taken in basic and secondary education. The role of information technology and the English language has been strengthened. Educational infrastructure and administration has been improved. Adopted just after the crisis, the National Reform Plan specifically included the promotion of research and development. R&D Expenditure was increased to 1.5 per cent the GDP in 2008, compared to 0.4% ten years ago (in 2008, the EU-average was 1,9%).[5]

Whether Portugal can avoid the fall depends on internal and external circumstances. Being a small, open economy, the consolidation of international markets is essential for Portugal. The situation in the EU and in neighbouring Spain is especially important. Domestically, a successful consolidation program with political consensus and the stability of the financial system would facilitate (the slow) recovery.

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[1] http://www.bloomberg.com/news/2011-01-12/ portugal-borrowing-costs-fall-at-auction-as-bailout-speculation-diminishes.html

[2] Afonso, A. – Claeys, P-Sousa, R.: Fiscal regime shifts in Portugal. WP no.41, School of Economics and management, Dept. Of Economics, Technical University of Lisbon, October 2009. p. 29

[3] Wirtschaftstrends Portugal Jahreswechsel 2008/09. Germany Trade and Invest, Dr. Georg Oster. www.gtai.de

[4] Stability and Growth Programme 2010-2013 p.61.

[5] Source: Eurostat