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EURO ZONE CRISIS: A COMPREHENSIVE ANALYSIS WITH SPECIAL EMPHASIS ON PORTUGAL

Abstract:

Eurozone Crisis: A Comprehensive Analysis with Special Emphasis on Portugal

In 1992, the Maastricht Treaty formally created the European Union as the move towards a common market soon revealed a need for monetary coordination, and this eventually led to the circulation of the euro currency in January 2002. Nineteen of the twenty-eight EU member states are part of the EuroZone, while other EU states, including Bulgaria, the Czech Republic, Hungary, Poland, and Romania, are required by treaty to eventually join. Even if the euro is destined to replace the dollar, it will happen slowly, and not cause a dollar collapse. Another reason why the shift to the euro, if it occurs, would happen slowly is because of the eurozone crisis. The European debt crisis is a multi-year debt crisis that has been taking place in several eurozone member states since the end of 2009. These states (Greece, Portugal, Ireland, Spain, Cyprus) were unable to repay or refinance their government debt or to bail out over-indebted banks under their national supervision without the assistance of third parties like the EFSF, the ECB, or the IMF.

Portugal's foreign debt-financed deficit—over 10 percent of GDP in 2009—meant that when investors withdrew, the country could no longer finance itself. This paper aims to draw a parallel between the Portuguese crisis and other European countries in similar situations with an in-depth analysis of the foreign exchange structure prevalent in the Eurozone. It will also infer common points surrounding these crises and examine possible solutions and safeguards for the future.

Keywords:

eurozone crisis, portugal, european union

JEL Classification: F00

REVIEW OF LITERATURE

The 2008 financial crisis revealed the weaknesses, the chronic problems and the differences which were lurking and emerged between the member states. The disparities of the economies combined with asymmetric monetary policy and political failures of member states exacerbated the problem resulting in the loss of credibility of some member states. The most vulnerable countries were those which are facing chronic debt problems and those which have directly affected by the financial crisis.

In 2007, EU economies, on the surface, seemed to be doing relatively well – with positive economic growth and low inflation. Public debt was often high, but (apart from Greece) it appeared to be manageable assuming a positive trend in economic growth.

However, the global credit crunch (see: Credit crunch explained) changed many things.

1. Bank Loses. During the credit crunch, many commercial European banks lost money on their exposure to bad debts in US (e.g. subprime mortgage debt bundles)
2. Recession. The credit crunch caused a fall in bank lending and investment; this caused a serious recession (economic downturn). See: cause of recession
3. Fall in House Prices. The recession and credit crunch also led to a fall in European house prices which increased the losses of many European banks.
4. Recession caused a rapid rise in government debt. The recession caused a steep deterioration in government finances. When there is negative growth, the government receives less tax: (less people working = less income tax; less people spending = less VAT; less company profits = less corporation tax e.t.c.) (The government also has to spend more on unemployment benefits.)
5. Rise in Debt to GDP ratios. The most useful guide to levels of manageable debt is the debt to GDP ratio. Therefore, a fall in GDP and rise in debt means this will rise rapidly. For example, between, 2007 and 2011, UK public sector debt almost doubled from 36% of GDP to 61% of GDP (UK Debt – and that excludes financial sector bailout). Between 2007 and 2010, Irish government debt rose from 27% of GDP to over 90% of GDP (Irish debt).

Apart from the US Dollar, the next big currency in the world economy is euro. The move toward a common market soon revealed a need for monetary coordination. In 1992,

the Maastricht Treaty formally created the European Union, and led to the circulation of the euro currency in January 2002. Nineteen of the twenty-eight EU member states are part of the euro zone, while other EU states, including Bulgaria, the Czech Republic, Hungary, Poland, and Romania, are required by treaty to eventually join. Denmark and the UK were granted exemptions. In 2007, former Federal Reserve Chairman Alan Greenspan argued that the euro could replace the dollar as a global currency. However, even if the euro is destined to replace the dollar, it will happen slowly, and not cause a dollar collapse. Another reason why the shift to the euro, if it occurs, would happen slowly is because of the euro zone crisis. The European debt crisis is a multi-year debt crisis that has been taking place in several euro zone member states since the end of 2009. These states (Greece, Portugal, Ireland, Spain, Cyprus) were unable to repay or refinance their government debt or to bail out over-indebted banks under their national supervision without the assistance of third parties like the EFSF, the ECB, or the IMF.

Portugal's foreign debt-financed deficit—over 10 percent of GDP in 2009—meant that when investors withdrew, the country could no longer finance itself. By May 2011, the country needed a \$116 billion bailout package. Portugal exited the bailout program in May 2014. Growth in the periphery resumed: Ireland is set to be the fastest growing euro zone economy in 2015, having expanded 5 percent in 2014. Portugal is expected to expand 1.5 percent in 2015.

When the euro monetary union was established, it was introduced a common monetary policy which will be determined by the European Central Bank (ECB). The move prohibits member states of the euro zone to act autonomously printing money and confounded the role of the central banks of the Euro zone countries. Furthermore, the legal framework that defines the existence and the functions of the ECB limits the institution for acting at issues related to monetary policy. In other monetary unions such as the United States, the Federal Reserve may be used as emergency lender and fund states with debt problems. Additionally, if any of the States defaults, the pensions and the wages provided by the state will be covered by the Fed. E.C.B. does not have these features. Jurisdictions are limited to borrowing the European banks and the establishment of the interest rate. A further disadvantage is the autonomy of fiscal policy. The Euro zone has single monetary policy without having a common fiscal policy. Member states while are obliged to follow fiscal rules, there is not any official body which implements these rules and regulations. These enabled the Euro zone countries to borrow brazenly and increase their public debt, canceling in practice the Maastricht Treaty. Countries with debt problems which could pay its creditors by printing money found themselves threatened with default. In which case the only way to repay their creditors was that of internal devaluation.

As internal devaluation defines a series of activities such as spending cut, wage cuts and pension, increases in indirect taxes and easing of labor relations. The lack of

independent monetary policy, the trade deficits that several countries had in conjunction with the internal devaluation made the debt crisis in the euro area to be impenetrable.

The inability of Euro zone member states to restore competitiveness through currency devaluation should be addressed through differentiated inflation targets for different regions. Forcing all the burden of the competitiveness adjustment on the debtor countries makes it more difficult to achieve nominal GDP growth and therefore debt sustainability. Higher levels of inflation and wage growth in the more competitive core is the only way, at least in the short-run, to successfully reconcile the twin goals of rebalanced competitiveness and reasonable nominal GDP growth in the periphery. Full fiscal federalism is not necessary. However, the Euro zone does need a mechanism to soften the impact of recessions and asymmetric shocks. A centralized inter-regional insurance fund to provide direct financial support to troubled economies under strict guidelines would fill this role. The fund could be required to run a surplus over the course of the economic cycle and could be funded from a common Euro zone consumption tax. We must restore the social element to economic policy making. The new six-pack rules should be expanded to monitor indicators such as poverty rates and income distribution, while the rules of the fiscal treaty should be expanded to incorporate growth, development and social justice considerations. We can solve the design flaws but it is not sufficient simply to preserve the euro. The type of Euro zone that survives is crucial. This paper basically deals with the euro debt crisis in detail with special reference to the economic situation in Portugal. It also focuses on the present situation of Portugal and tries to provide projections for the future. The conclusion deals with the suggestions and a complete outlook of the economic condition of Portugal as well as the complete Europe.

I.INTRODUCTION: WHAT IS EURO DEBT CRISIS?

The European debt crisis (often also referred to as the Euro zone crisis or the European sovereign debt crisis) is a multi-year debt crisis that has been taking place in the European Union since the end of 2009. Several euro zone member states (Greece, Portugal, Ireland, Spain and Cyprus) were unable to repay or refinance their government debt or to bail out over-indebted banks under their national supervision without the assistance of third parties like the EFSF, the ECB, or the IMF.¹ First Greece -- then Ireland, Italy, Spain and Portugal: The European common currency has come under pressure from large national debts and the effects of the global financial crisis, ultimately requiring a rescue package close to a trillion Euros.

¹ https://en.wikipedia.org/wiki/European_debt_crisis

The euro crisis is primarily a function of the inability of Euro zone member states to print their own currency. This inability means these countries can run out of money and are therefore exposed to insolvency risks. This inability means these countries can run out of money and are therefore exposed to insolvency risks. An essential component of crisis resolution is to eliminate the possibility of sovereign default by any member state exhibiting a demonstrated willingness to pursue sustainable fiscal policies. To achieve this goal a conditional Lender of Last Resort (LOLR) for sovereign borrowers must be established. The European Stability Mechanism (ESM), as designed, is not an LOLR and has an inherently fragile structure. Mutual debt issuance proposals such as most of the various Eurobond models come attached with substantial moral hazard risks.²

I.(A) WAS THE EUROZONE CRISIS AVOIDABLE?

To answer whether the recent crisis in the Euro zone was inevitable, we must look at whether the Euro zone is suitable for the countries that are part of it. The previous section outlined some of the benefits and costs of EMUs in general. This section uses suitable criteria to evaluate the EU EMU (the Euro zone) in particular. Evaluating the viability of the Euro zone: Analysis of the viability of economic and monetary unions is linked to the concept of an 'optimum currency area' pioneered by the economist Robert Mundell in 1961. We can use Mundell's criteria to evaluate the suitability of the Euro zone countries to form an EMU:

1) Labor mobility. Enabling workers to freely move around and between the different economies is necessary to efficiently distribute workers where they are needed. The Euro zone does not score highly on this point; language is a significant barrier to labor mobility, as is the limited transferability of qualifications between different states.

2) Openness with capital. Free movement of capital is important as it allows companies and people to invest across national borders, and it allows banks to conduct business across the EMU. Fewer than 5% of commercial bank loans are issued across EU states' borders. However, this is likely to increase because the EU made restrictions on capital movements illegal in the early 1990's and has since been ensuring that restrictions are removed (although there are some exceptions).

3) Wage and price flexibility. This allows the differences between the supply and demand for labour to be affected, perhaps through reducing wages or working hours. The Eurozone does not score highly on this point. Wage flexibility is affected by unionization (workers who are members of unions), and by national labor laws and controls.

² Tom McDonnell1, *The Euro Crisis: Causes and Solutions*, TASC Discussion Paper, July 2012

4) Fiscal transfer mechanism. This is the ability to transfer funds between members of the union in response to economic shocks. A country does this by taxing citizens and redistributing the funds where they are needed. At present the Euro zone has no fiscal transfer mechanism, although some funding is given to underdeveloped region via the EU Budget (e.g. the Structural and Cohesion Funds).

5) Similar business cycles. This is necessary for a central bank to develop a cohesive policy for the whole region during recessions or periods of growth. Some Euro zone economies do exhibit a high degree of business cycle synchronization. However, not all do, and some economies do show quite a low level of synchronization

6) Similar economic structures. EMU members' output (the amount they produce) needs to be the result of similar economic sectors. For instance, the countries in the EMU must have similar outputs from the service, agriculture, financial sectors, etc. The Euro zone's suitability is mixed in this regard, some members' economies display high levels of convergence in terms of structure, but there are many incongruities; for example, France has a much larger agricultural base than Germany, which has a larger manufacturing base.

7) Integrated goods markets. Economies that have a high level of trade with each other are better placed to integrate. The Euro zone does reasonably well in this regard, although there is debate about whether intra-EU trade has grown since the adoption of the EMU, and about the extent to which trade in goods and services is integrated as a percentage of overall GDP. The fact that the Euro zone does not fulfill Mendel's criteria in many respects, suggests that it is a 'suboptimum' currency area. There is, however, much debate about what this means for the future of the Euro zone. Some commentators suggest that it means the Euro zone is unviable, others say it simply shows that the Euro zone needs further fiscal and redistribute reform to become an optimum currency area.

The key question is: did the problem of 'sub-optimality' make the recent Euro zone crisis inevitable, or were other, perhaps avoidable, factors to blame?

In Europe, the lack of insight and solidarity among member states of the Euro zone made euro look weak and stripped in front of the challenges of the financial markets. The funding of countries that have a debt problem from the EFSF exacerbated the situation and was seen as a short-lived embankment. The insistence of austerity made countries which have debt problem sinking into recession, without any apparent prospect for growth. Some say that the euro crisis was avoidable. It is a self inflicted crisis and the consequence of systemic policy failures in the way European Monetary Union (EMU) was designed, constructed and implemented. The severity of the crisis has itself been greatly exacerbated by the profound mismanagement of Euro zone

leaders and by its misdiagnosis as a crisis of fiscal discipline, where, Greece apart, it is really a system crisis with its roots in the design flaws of the currency union itself. Some argue that a 'sub-optimal' EMU will always be subject to crises because it doesn't have a central body to direct activity. The Euro zone debt crisis could have been avoided if except for the common monetary policy and there was a common fiscal policy. The lack of a common fiscal policy made (at some extent) the euro to be vulnerable to any endogenous problem of a member state. Noteworthy is also the lack of political will of several Euro zone governments to make appropriate reforms in the economy of their countries. If they had done the appropriate moves before the credit crisis the economies within the Euro zone would have the adequate structures to withstand and overcome the crisis. In this period with the recession dominating on a permanent basis is very difficult to implement the needed reforms but also to be efficient in order the countries to become more competitive. They argue that the Euro zone has a 'coordination problem' and that the Euro zone crisis was inevitable because it doesn't have the political structures to coordinate member states' economic actions by setting rules to prevent countries from pursuing their self-interest in damaging ways. It appears that policymakers have failed to learn the lessons of the Great Depression of the 1930s and the long Japanese stagnation of the 1990s. The current responses to the crisis to date have been insufficient and in some cases even counterproductive.³

II. EUROZONE CRISIS: AN ANALOGICAL ORDER FOR THE TURN OF EVENTS

The euro, the dream of many a politician in the years following World War II, was established in Maastricht by the European Union (EU) in 1992. To join the currency, member states had to qualify by meeting the terms of the treaty in terms of budget deficits, inflation, interest rates and other monetary requirements. Among all the EU members at the time, the UK, Sweden and Denmark declined to join the currency. Since then, there have been many twists and turns for the countries that use the single currency.

YEAR 1999

On 1 January, the currency officially comes into existence.

YEAR 2001

Greece joins the euro.

YEAR 2002

On 1 January, notes and coins are introduced.

³ Tom McDonnell1, *The Euro Crisis: Causes and Solutions*, TASC Discussion Paper, July 2012

YEAR 2008

Malta and Cyprus join the euro, following Slovenia the previous year. In December, EU leaders agree on a 200bn-euro stimulus plan to help boost European growth following the global financial crisis.

YEAR 2009

Slovakia joins the euro. Estonia, Denmark, Latvia and Lithuania join the Exchange Rate Mechanism to bring their currencies and monetary policy into line with the euro in preparation for joining.

In April, the EU orders France, Spain, the Irish Republic and Greece to reduce their budget deficits - the difference between their spending and tax receipts.

In October, amid much anger towards the previous government over corruption and spending, George Papandreou's Socialists win an emphatic snap general election victory in Greece.

In November, concerns about some EU member states' debts start to grow following the Dubai sovereign debt crisis.

In December, Greece admits that its debts have reached 300bn euros - the highest in modern history.

Greece is burdened with debt amounting to 113% of GDP - nearly double the eurozone limit of 60%. Ratings agencies start to downgrade Greek bank and government debt.

Mr. Papandreou insists that his country is "not about to default on its debts".

YEAR 2010

In January, an EU report condemns "severe irregularities" in Greek accounting procedures. Greece's budget deficit in 2009 is revised upwards to 12.7%, from 3.7%, and more than four times the maximum allowed by EU rules. The European Central Bank dismisses speculation that Greece will have to leave the EU.

In February, Greece unveils a series of austerity measures aimed at curbing the deficit. Concern starts to build about all the heavily indebted countries in Europe - Portugal, Ireland, Greece and Spain. On 11 February, the EU promises to act over Greek debts and tells Greece to make further spending cuts. The austerity plans spark strikes and riots in the streets.

In March, Mr. Papandreou continues to insist that no bailout is needed. The euro continues to fall against the dollar and the pound. The euro zone and IMF agree a safety net of 22billion Euros to help Greece - but no loans.

In April, following worsening financial markets and more protests, euro zone countries agree to provide up to 30billion Euros in emergency loans. Greek borrowing costs reach yet further record highs. The EU announces that the Greek deficit is even worse than thought after reviewing its accounts - 13.6% of GDP, not 12.7%.

Finally, on 2 May, the euro zone members and the IMF agree a 110bn-euro bailout package to rescue Greece. The euro continues to fall and other EU member state debt starts to come under scrutiny, starting with the Republic of Ireland.

In November, the EU and IMF agree to a bailout package to the Irish Republic totaling 85billion Euros. The Irish Republic soon passes the toughest budget in the country's history.

Amid growing speculation, the EU denies that Portugal will be next for a bailout.

YEAR 2011

On 1 January, Estonia joins the euro, taking the number of countries with the single currency to 17.

In February, euro zone finance ministers set up a permanent bailout fund, called the European Stability Mechanism, worth about 500billion Euros.

In April, Portugal admits it cannot deal with its finances itself and asks the EU for help.

In May, the euro zone and the IMF approve a 78bn-euro bailout for Portugal.

In June, euro zone ministers say Greece must impose new austerity measures before it gets the next tranche of its loan, without which the country will probably default on its enormous debts.

Talk abounds that Greece will be forced to become the first country to leave the euro zone.

In July, the Greek parliament votes in favor of a fresh round of drastic austerity measures, the EU approves the latest tranche of the Greek loan, worth 12bn Euros. A second bailout for Greece is agreed. The euro zone agrees a comprehensive 109bn-euro (\$155bn; £96.3bn) package designed to resolve the Greek crisis and prevent contagion among other European economies.

In August, European Commission President Jose Manuel Barroso warns that the sovereign debt crisis is spreading beyond the periphery of the euro zone. The yields on government bonds from Spain and Italy rise sharply - and Germany's falls to record lows - as investors demand huge returns to borrow.

On 7 August, the European Central Bank says it will buy Italian and Spanish government bonds to try to bring down their borrowing costs, as concern grows that the debt crisis may spread to the larger economies of Italy and Spain. The G7 group of countries also says it is "determined to react in a co-ordinate manner," in an attempt to reassure investors in the wake of massive falls on global stock markets.

During September, Spain passes a constitutional amendment to add in a "golden rule," keeping future budget deficits to a strict limit. Italy passes a 50bn-euro austerity budget to balance the budget by 2013 after weeks of haggling in parliament. There is fierce public opposition to the measures - and several key measures were watered down. The European Commission predicts that economic growth in the euro zone will come "to a virtual standstill" in the second half of 2011, growing just 0.2% and putting more pressure on countries' budgets. Greek Finance Minister Evangelos Venizelos says his country has been "blackmailed and humiliated" and a "scapegoat" for the EU's incompetence.

On 19 September, Greece holds "productive and substantive" talks with its international supporters, the European Central Bank, European Commission and IMF. The following day, Italy has its debt rating cut by Standard & Poor's, to A from A+. Italy says the move was influenced by "political considerations". That same day, in its World Economic Outlook, the IMF cuts growth forecasts and warns that countries are entering a 'dangerous new phase'.

The gloomy mood continues on 22 September, with data showing that growth in the euro zone's private sector shrank for the first time in two years. The sense of urgency is heightened on 23 September, when IMF head Christine Lagarde urges countries to "act now and act together" to keep the path to economic recovery on track. On the same day, UK Prime Minister David Cameron calls for swift action on the debt crisis. The next day US Treasury Secretary Timothy Geithner tells Europe to create a "firewall" around its problems to stop the crisis spreading. A meeting of finance ministers and central bankers in Washington on 24 September leads to more calls for urgent action, but a lack of concrete proposals sparks further falls in share markets. After days of intense speculation that Greece will fail to meet its budget cut targets, there are signs of a euro zone rescue plan emerging to write down Greek debt and increase the size of the bloc's bailout fund. But when, on 28 September, European Union head Jose Manuel Barroso warns that the EU "faces its greatest challenge", there is a widespread view that the latest efforts to thrash out a deal have failed. The sense that events are spinning out of

control are underlined by Foreign Secretary William Hague, who calls the euro a "burning building with no exits".

On 4 October, Euro zone finance ministers delay a decision on giving Greece its next installment of bailout cash, sending European shares down sharply. Speculation intensifies that European leaders are working on plans to recapitalize the banking system. On 6 October the Bank of England injects a further £75bn into the UK economy through quantitative easing, while the European Central Bank unveils emergency loans measures to help banks. Financial markets are bolstered by news on 8 October that the leaders of Germany and France have reached an accord on measures to help resolve the debt crisis. But without publication of any details, nervousness remains. Relief in the markets that the authorities will help the banking sector grows on 10 October, when struggling Franco-Belgian bank Dexia receives a huge bailout. On 10 October, an EU summit on the debt crisis is delayed by a week so that ministers can finalize plans that would allow Greece its next bailout money and bolster debt-laden banks. On 14 October G20 finance ministers meet in Paris to continue efforts to find a solution to the debt crisis in the euro zone. On 21 October euro zone finance ministers approve the next, 8bn euro (\$11bn; £7bn), tranche of Greek bailout loans, potentially saving the country from default. On 26 October European leaders reach a "three-pronged" agreement described as vital to solve the region's huge debt crisis. After marathon talks in Brussels, the leaders say some private banks holding Greek debt have accepted a loss of 50%. Banks must also raise more capital to protect them against losses resulting from any future government defaults.

On 9 December, after another round of talks in Brussels going through much of the night, French President Nicolas Sarkozy announces that euro zone countries and others will press ahead with an inter-governmental treaty enshrining new budgetary rules to tackle the crisis. Attempts to get all 27 EU countries to agree to treaty changes fail due to the objections of the UK and Hungary. The new accord is to be agreed by March 2012, Mr Sarkozy says.

YEAR 2012

On 13 January, credit rating agency Standard & Poor's downgrades France and eight other euro zone countries, blaming the failure of euro zone leaders to deal with the debt crisis. Three days later, the agency also downgrades the EU bailout fund, the European Financial Stability Facility. Also on 13 January, talks between Greece and its private creditors over a debt write-off deal stall. The deal is necessary if Greece is to receive the bailout funds it needs to repay billions of Euros of debt in March. The talks resume on 18 January. The "fiscal pact" agreed by the EU in December is signed at the end of January. The UK abstains, as does the Czech Republic, but the other 25 members sign up to new rules that make it harder to break budget deficits. Weeks of negotiations

ensue between Greece, private lenders and the "troika" of the European Commission, the European Central Bank and the IMF, as Greece tries to get a debt write-off and make even more spending cuts to get its second bailout.

On 10 February, Greece's coalition government finally agrees to pass the demands made of it by international lenders. This leads to a new round of protests. But the euro zone effectively casts doubt on the Greeks' figures, saying Athens must find a further 325m Euros in budget cuts to get the aid. On 12 February, Greece passes the unpopular austerity bill in parliament - two months before a general election. Coalition parties expelled more than 40 deputies for failing to back the bill. On February 22, a Market survey reports that the euro zone service sector has shrunk unexpectedly, raising fears of a recession. The next day the European Commission predicts that the euro zone economy will contract by 0.3% in 2012.

March begins with the news that the euro zone jobless rate has hit a new high. However, the economic news takes a turn for the better just days later with official figures showing that the euro zone's retail sales increased unexpectedly in January by 0.3%, and the OECD reports its view that the region is showing tentative signs of recovery. On 13 March, the euro zone finally backs a second Greek bailout of 130bn Euros. IMF backing was also required and was later given. The month ends with a call from the OECD for the euro zone rescue fund to be doubled to 1trillion Euros. The German chancellor, Angela Merkel says she would favor only a temporary boost to its firepower.

On 12 April, Italian borrowing costs increase in a sign of fresh concerns among investors about the country's ability to reduce its high levels of debt. In an auction of three-year bonds, Italy pays an interest rate of 3.89%, up from 2.76% in a sale of similar bonds the previous month. Attention shifted to Spain the next day, with shares hit by worries over the country's economy and the Spanish government's 10-year cost of borrowing rose back towards 6% - a sign of fear over the country's creditworthiness. On 18 April, the Italian government cut its growth forecast for the economy in 2012. It was previously predicting that the economy would shrink by 0.4%, but is now forecasting a 1.2% contraction. On 19 April, there was some relief for Spain after it saw strong demand at an auction of its debt, even though some borrowing costs rose. The 10-year bonds were sold at a yield of 5.743%, up from 5.403% when the bonds were last sold in February.

On 6 May, a majority of Greeks vote in a general election for parties that reject the country's bailout agreement with the EU and International Monetary Fund. On 16 May, Greece announces new elections for 17 June after attempts to form a coalition government fail. On 25 May, Spain's fourth largest bank, Bankia, says it has asked the government for a bailout worth 19bn Euros (\$24bn; £15bn).

On 9 June, after emergency talks Spain's Economy Minister Luis de Guindos says that the country will shortly make a formal request for up to 100bn Euros (\$125bn; £80bn) in loans from euro zone funds to try to help shore up its banks. On 12 June, optimism over the bank bailout evaporates as Spain's borrowing costs rise to the highest rate since the launch of the euro in 1999. On 15 June, former UK Chancellor of the Exchequer Gordon Brown underlined fears of contagion with a warning that France and Italy may need a bailout. On 17 June, Greeks went to the polls, with the pro-austerity party New Democracy getting most votes., allaying fears the country was about to leave the euro zone.⁴

III. A BRIEF INSIGHT INTO THE PORTUGAL CRISIS

In April 2011 Portugal became the third country in a row, after Greece and Ireland, to receive a bailout from the 'Troika' of the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF). Financial markets began to become suspicious about the ability of the country to fulfill its sovereign debt liabilities, risk premiums increased up to a point where access to capital markets was no longer an option and a debt default soon became imminent. At this point the Portuguese minority Socialist government of José Sócrates had no option other than to negotiate a bailout in the form of a memorandum of understanding with the three lending consortia – the EC, ECB and IMF.⁵The Economy of Portugal is of a mixed nature and functions in support of a high income country. The Global Competitiveness Report for 2014-2015, published by the World Economic Forum, placed Portugal on the 36th position on the economic index. ⁶Portugal's ranking had been falling since 2005 (with the exception of 2011) ⁷but recovered from the 51st position in 2013 to the 36th in 2014.⁸ The Portuguese currency is the euro (€) and the country has been a part of the euro zone since its inception. Portugal's central bank is the *Banco De Portugal*, which forms part of the European system of central banks, and the major stock exchange is the euronext Lisbon, which belongs to the NYSE euronext, the first global stock exchange.⁹

A long run perspective (1974-2011) on management of public finances shows that Portugal has some institutional and constitutional problems that should be sorted out in order to achieve sound public finances. Moreover, in the second half of the 90s fiscal policy was expansionary and the high conversion rate of the former currency (escudo) to the euro still hampers economic growth and competitiveness. With weak growth in the first decade of XXI century and persistent public and external deficits, Portugal

⁴ <http://www.bbc.com/news/business-13856580>

⁵ Paulo T. Pereira & Laura Wemans, *Portugal and the Global Financial Crisis –short-sighted politics, deteriorating public finances and the bailout imperative*, university of Lisbon, July 2012, page 3

⁶ http://www3.weforum.org/docs/GCR2013-14/GCR_Rankings_2013-14.pdf

⁷ <http://www.publico.pt/economia/noticia/portugal-desce-dois-lugares-no-ranking-da-competitividade-1604866>

⁸ <http://www.ionline.pt/artigos/dinheiro/competitividade-portugal-sobe-15-lugares-no-ranking-mundial/pag/-1>

⁹ <http://www.rimes.com/nyse-euronext-lisbon-portugal>

came to the frontline of the negative impacts of the GFC. The total absence of political cooperation and the existence of some minority governments only made these things worst.¹⁰

III(A) .RELATIONSHIP OF POLITICS AND PUBLIC FINANCE IN PORTUGAL

To understand the situation in the countries at the periphery of the European Union, four countries within the Euro zone, Portugal, Ireland, Greece and Spain, we have to understand the political context they have in common. All of them were governed by fascist or fascist-like dictatorships (Spain, Portugal, and Greece) or by authoritarian right-wing regimes (Ireland) for most of the period from the late 1930s or early 1940s until the late 1970s. This shared history, however, has determined the nature of their states, a critical variable for understanding countries' economic behavior. Their states have been very repressive. Even today, these countries have the largest number of policemen per 10,000 individuals in the EU-15. Another shared characteristic is their very low level of state revenues and their highly regressive fiscal policies. The revenues to the state are much lower than the EU-15 average: approximately 34% of GNP in Spain, 37% in Greece, 39% in Portugal, and 34% in Ireland, compared with the EU-15 average of 44%, and compared with 54% in Sweden – the EU-15 country where the left has governed for the longest period. The low state revenues result from extremely regressive policies. The super-rich, rich, and high-income upper middle classes do not pay taxes at the same level and intensity as those in most of the central and northern EU-15 countries – a consequence of a history of government by ultra-right-wing parties. Public expenditure in Portugal has been a challenge for fiscal control and overall competitiveness. Past expenditure trends have not been reassuring as can be seen from Figure 3, with primary expenditure averaging 23.5, 31.6, and 35.5 per cent of GDP respectively in the 1970s, 1980s, and 1990s, and reaching an average of 42.9 per cent between 2000 and 2006. Naturally, this development tracked, to some extent, the upward trend in public spending in the EU15 countries in the past three decades, where a significant increase in the total expenditure-to-GDP ratio also occurred from 1970 until the beginning of the 1990s, from 35.4 per cent of GDP in 1970 to around 50 per cent of GDP in 1993-1995. Thereafter, the total expenditure ratio declined in the EU15 but continued to increase in Portugal. The limitations imposed by the need to ensure sound public finances, notably in order to meet the Maastricht fiscal criteria, led most EU countries to curb down public expenditure behavior from the mid-1990s onwards. Portugal was the first country in the EU to breach the SGP in 2001, becoming subject to the EDP in 2002, a situation that occurred again in 2005. After the first EDP for Portugal, both Germany and France also breached the 3 per cent limit for the budget deficit in 2002, and become subject to an identical procedure respectively in 2002 and

¹⁰ Paulo T. Pereira & Laura Wemans ,*Portugal and the Global Financial Crisis –short-sighted politics, deteriorating public finances and the bailout imperative*, university of Lisbon, July 2012,page 1

in 2003.¹¹ Portugal's difficulties and experiences with excessive deficit situations are not an exception in the EU. As a matter of fact, in the last years other members of the EU also faced an EDP (in the euro area Portugal, Greece, France, Germany and Italy were undergoing an EDP at the end of 2006).¹² Of course, progress has been made since the dictatorships ended. But the dominance of conservative forces in the political and civil lives of these countries explains why their state revenues are still so low. As a result, the public sectors in Portugal, Ireland, Greece, and Spain are extremely underdeveloped. And their welfare states are poorly funded and very limited, including their public transfers (pensions) and public services (medical care, education, childcare services, homecare services, social services, and others). Indicators of this are many. One example is public social spending as percentage of GNP, which is lower in these countries than the EU-15 average (27%): Spain, 22.1%; Greece, 25.9%; Portugal, 24.3%; and Ireland, 22.1% (compared with Sweden, 29.3%). Another example is the percentage of the adult population working in public services of the welfare state – again, lower than the EU-15 average (15%): Spain, 9%; Greece, 11%; Portugal, 7%; and Ireland, 12% (compared with Sweden, 25%). In fact, Greece's percentage is three points higher, 14%, because it includes services for the military, (which represents approximately 30% of public employees).¹³ Thus, for these four countries, not enough attention has been paid in the economic literature to the consequences of being governed by ultra-conservative forces. The influence of such forces has been enormous. Before the financial crisis there was an economic crisis, largely the result of the decline in labor income as percentage of total national income. The neoliberal policies developed since the 1980s (accentuated over the past 15 years, and carried out by governments of various political persuasions, including social democratic, in Spain, Greece, and Portugal) have had a strong impact on income distribution, accelerating the concentration of income in the high income brackets. The decline of labor-derived income diminished the purchasing power of the popular classes, forcing them into debt in order to maintain their standard of living. And credit was relatively easy to obtain, because house values were rising and provided a means of borrowing from banks by putting up homes as security. The growth of the credit sector (and of financing) was based on the decline of labor income. But the decline of labor income was creating a major problem for demand and limited profitability in the economy. With this limited profitability in the productive economy, the super-rich, rich, and upper-income middle class invested in sectors with higher returns, especially in real estate. The deregulation of banking (and deregulation of zoning laws) during the 1990s led to a real estate bubble, based on the complex of banking, real estate, and construction

¹¹ The Stability and Growth Pact consists of a Resolution of the European Council of 17 June 1997, published on 2 August 1997, and of two Regulations of the European Council, N.º 1466/97 and N.º

¹² By the end of 2006, other countries already faced an EDP: Czech Republic, Cyprus, Hungary, Malta, Poland, and Slovak Republic. Additionally, in 2004 both the UK and the Netherlands found themselves in excessive deficit, vis-à-vis the 2003 budget deficit outcome.

¹³ <http://www.vnavarro.org/> *the crisis and fiscal policies of eurozone*/page 2

industries. Some of the experiences of Portugal, both the preparation to the euro and the euro experience itself, may provide useful insights to the EU new Member States that will adopt the single currency in the future. Indeed, one must be aware of the implications and requisites of the need of sound fiscal policies coupled with a single monetary policy, in order to adjust procedures and take full advantage of such policy environment. Finally, one can briefly sketch some desirable features that should surround the implementation of fiscal policy in Portugal: fiscal policy should not be pro-cyclical; consolidations need to be pursued in order to attain a sound fiscal position that can deal with unforeseen shocks and prepare for the future fiscal costs of ageing populations; structural measures rather than temporary ones should be favoured; the fiscal authorities should monitor, collect, and provide comprehensive fiscal data in a timely fashion for all sub-sectors of the general government; a periodical assessment of public finances objectives and implementation, from an autonomous perspective, would also be welcomed to help steer fiscal policy decisions towards a sustainable path.

III (B). AFFECT OF THE CRISIS IN PORTUGAL: REASONS

The reasons why Portugal was not prepared and could not respond adequately to the GFC were not only fiscal but also economic and political. Since the restoration of democracy in 1976, the IMF has been involved in an enforced fiscal consolidation program in Portugal on three different occasions. The usual pattern of public finances was: firstly, a significant increase in public spending compared to GDP would occur leading to permanent deficits; secondly, higher deficits led to an increase of the debt to GDP ratio mainly in periods of low growth; thirdly, with the level of debt soaring, a privatization program was imposed on the government together with a restrictive fiscal policy (see Pereira 2012). The recent bailout of Portugal by the EC, IMF and ECB is, therefore, not a completely new story. Portugal was definitely not prepared for the GFC from the public finance point of view. However, as clarified below, the banking and financial sector was relatively robust and the housing bubble was not as important as in other countries.

When the *Maastricht Treaty*, and the *Stability and Growth Pact* established the reference values for the ratio of debt to GDP (60 percent) and deficit to GDP (of 3 percent), economists and politicians looked to the past growth record and considered it reasonable to assume a 5 percent annual nominal GDP growth rate in European countries. If economic growth was maintained at that level public finances would be sustainable. Portugal had a reasonable growth record in the 1990s but than an appalling one in the first decade of this century, particularly in the years immediately preceding the crisis. Low growth was associated with low productivity and a significant loss of competitiveness related to several factors. First, low educational levels, which have been widely acknowledged (see OECD 2010), do not promote productivity increases. Second, a higher than expected exchange rate established for the

conversion of the former Portuguese currency (the escudo) to the euro brought further damage to external competitiveness. Third, an allocation of European Structural Funds, spent mainly on

Infrastructure and other non-tradable goods and services, which contributed to increase productivity in the former years after joining the EU (in 1986), but became a partial waste of resources in the last decade. Finally, rigidities in the labor and housing markets were also considerably damaging to economic growth, contributing to low mobility in the labor market and, along with low interest rates, promoted a high household indebtedness.¹⁴

Portugal, by contrast, had raised income taxes and allowed pensions to grow rapidly.¹⁵ Well before the financial crisis, Portugal's economy was in a slump. As Olivier Blanchard wrote in 2006, "The Portuguese economy is in serious trouble: Productivity growth is anemic. Growth is very low. The budget deficit is large.... In the absence of policy changes, the adjustment is likely to be long and painful.... Deficit reduction is required."¹⁶ But, between 2007 and 2010, Portugal increased non-transfer spending almost twice as much as Sweden and the average tax rate rose in Portugal while it fell significantly in Sweden. Needless to say, Sweden's growth rate and unemployment have been vastly better than Portugal's. Instead of catching up to the wealthier parts of Europe, Portugal's policies have dragged it further behind. The United States had some advantages going into the recession. U.S. labor markets have long been more flexible than those in most of Europe. The strong and steady pace of economic growth over the past 70 years made it easy for Americans and their government to repay past debts. The U.S. has avoided the worst of demographic collapse and does not face an age-dependency problem on the scale of Germany, Italy, or Japan. And U.S. public debt was around 40 percent of GDP.

Many of these advantages have been squandered, however, and the U.S. might have greater difficulty recovering from a future crisis. U.S. labor markets have become more rigid, and the Obama Administration is proposing a minimum wage increase to an unprecedented level. Economic growth has slowed and labor force participation is dropping. The baby boomers are beginning to retire. U.S. debt is now 74 percent of GDP, and the gathering storm of entitlement deficits looms near.

Crises tend to reveal and exacerbate an economy's underlying weaknesses. U.S. policymakers should identify and address the weaknesses that recent policies have

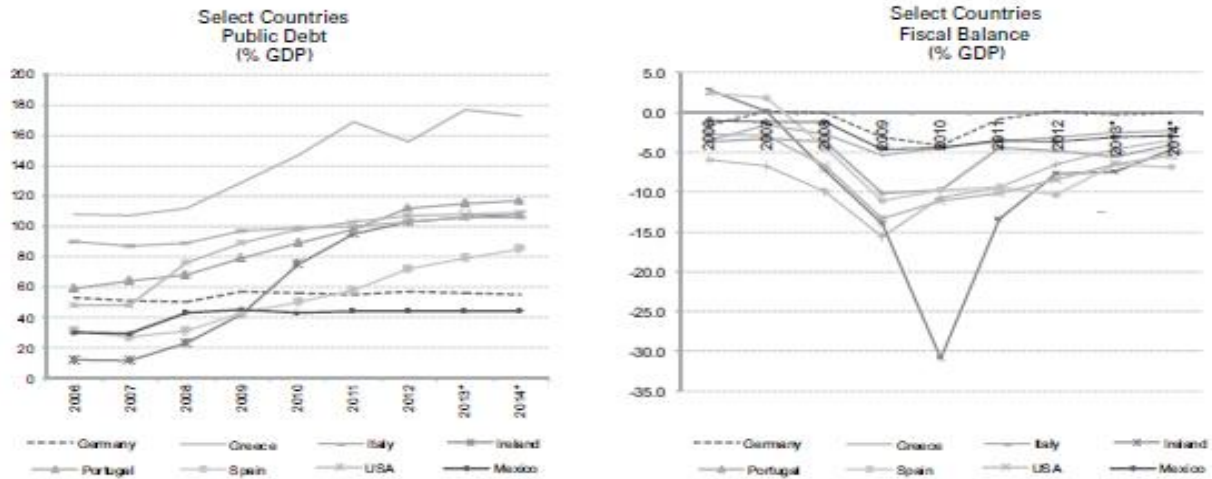
¹⁴ Paulo T. Pereira & Laura Wemans, *Portugal and the Global Financial Crisis –short-sighted politics, deteriorating public finances and the bailout imperative*, university of Lisbon, July 2012, page 4

¹⁵ Ricardo Reis, "The Portuguese Slump-Crash and the Euro-Crisis," paper presented at Brookings Institution Panel on Economic Activity, March 21, 2013, pp. 3–4, http://www.astrid-online.it/Dossier--d1/Studio/Reis_Brookings_Economic-Activity-panel_21-22_03_13.pdf (accessed April 16, 2014).

¹⁶ Olivier Blanchard, "Adjustment Within the Euro. The Difficult Case of Portugal," *Portuguese Economic Journal*, Vol. 6, No. 1 (April 2007), p. 5, <http://link.springer.com/article/10.1007%2Fs10258-006-0015-4> (accessed April 2, 2014).

created in the American economy. The figure below shows the fiscal balance as well as the public debt of few countries during the euro zone crisis.

Figure 1
External Conditions



Source: prepared by the authors on Fiscal Monitor data of International Monetary Fund (IMF)
*Projections

FIGURE 1: FISCAL POLICY AND PUBLIC DEBT DURING CRISIS

The Portuguese economy enjoyed a period of high growth rates, decreasing unemployment and a rapid catch-up to the EU average in the late 1990s. This was a result of stage two of the European Economic and Monetary Union heading to the euro. In fact Portugal benefitted from decreased nominal and real interest rates, which lead to an increased private and public demand and also increased indebtedness in both sectors. Fiscal policy in the second half of the 90s was expansionary, while other European countries profited from low interests to consolidate their public finances. Moreover, the Bank of Portugal and the European Monetary Institute (a predecessor of the European Central Bank) were overly optimistic about the ability of the Portuguese economy to withstand a high conversion rate of the former escudo. The first seven years of the XXI century presented a quite different picture.

Unemployment increased sharply from a low level of 4.5% in 2000 to 8.9% in 2007, and economic growth was anemic. There was a mild recession in 2003 (GDP contracted 0.9 percent) and growth rates were lower than 2 percent from 2004 until 2006. As a result of this period of lower growth, there came a halt to the economic convergence to EMU standards. Between 1995 and 2000 the Portuguese per capita GDP was clearly getting closer to the EMU average (it raised from a low 47.6 percent of EMU average to 55.4 percent). However, in the following five years period (2000 to 2005) this convergence was much slower, rising only to 57 percent – a level at which it has largely remained ever since. Taking into account this low growth environment, the year 2007 was a

particularly good one, as GDP growth was 2.4 percent that year. Moreover, exports indicated signs of improvement, posting growth rates of 11.5 percent and 7.6 percent in 2006 and 2007 respectively. Yet, even with an improvement in the trade balance, the country still presented a current account deficit of 10.1 percent of GDP in 2007.¹⁷

The Portuguese economy grew a seasonally-adjusted 0.4% over the previous period in Q2 2015, matching Q1's result. The reading marked the fifth consecutive quarter of growth and confirmed the gradual strengthening of the economy observed in 2014. Even though concerns of spillover effects from the Greek debt crisis have faded with Greece's third bailout program approval in the beginning of August, Portugal is still widely considered as the biggest credit risk in Europe after Greece. On 6 August, the IMF stated that there is a "tangible risk" that the budget deficit would breach the 3% of GDP limit imposed by the European Union. The IMF highlighted that the current economic recovery and beginning of a new political cycle following the general elections scheduled for 4 October represent a crucial opportunity to implement further structural reforms. Meanwhile, the latest polls are giving a small lead to the opposition Socialist Party (PS) against the ruling center-right coalition government, which has seen its popularity fall following four years of harsh austerity measures. Investment fell by nearly 35% between 2007 and 2014, more than twice the decline in the European Union as a whole. Business investment has started to increase again, driven by stronger prospects for internal and external demand, higher capacity utilization and the need to renew depleted capital stock. Still, the pick-up in investment observed in key euro area economies has yet to materialize in Portugal. Public and residential investment will continue to stay subdued, reflecting fiscal consolidation needs and high leverage ratios

¹⁷ Paulo T. Pereira & Laura Wemans, *Portugal and the Global Financial Crisis –short-sighted politics, deteriorating public finances and the bailout imperative*, university of Lisbon, July 2012, page 9

of households and firms in the construction sector.

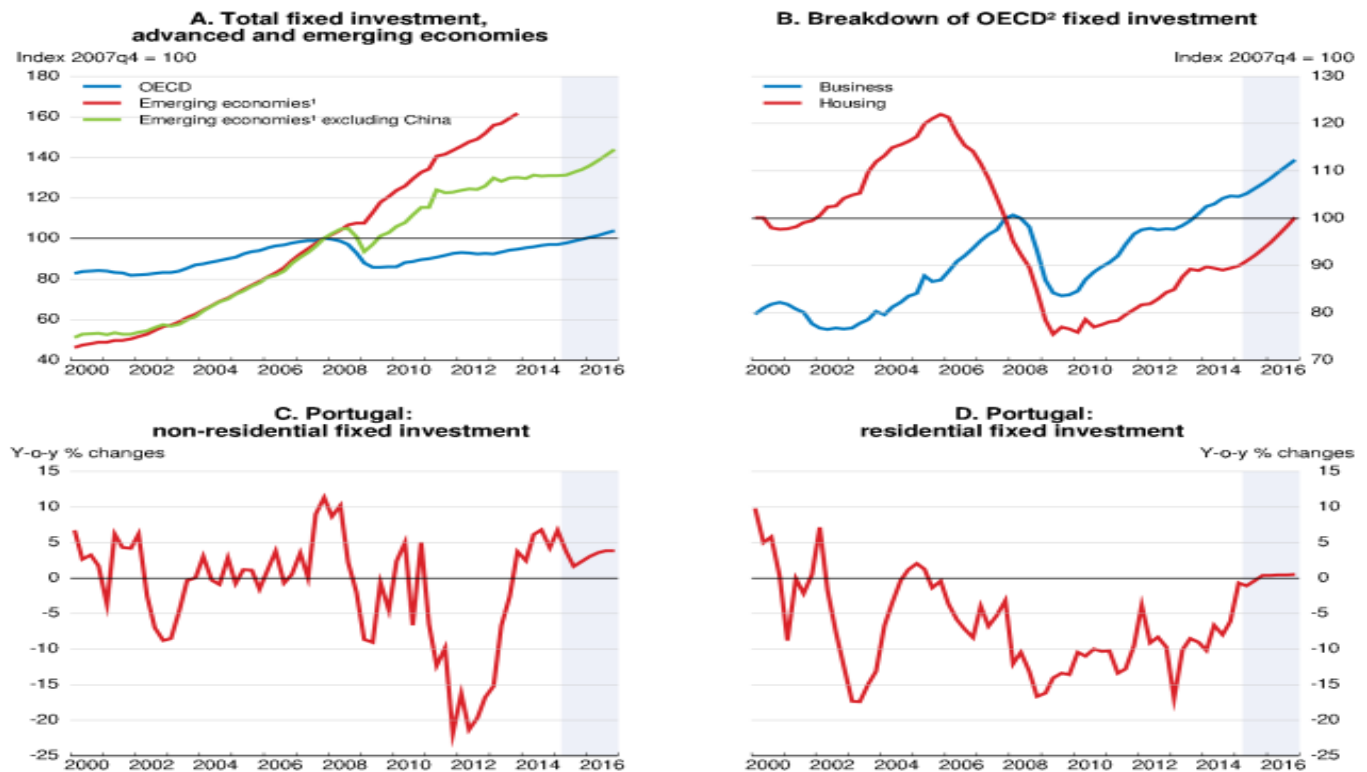


FIGURE 2: CURRENT PORTUGUESE ECONOMIC SITUATION

IV. ECONOMY OF PORTUGAL: CURRENT SCENARIO

Between May 2011 and June 2014, Portugal benefited from financial assistance in support of an economic adjustment program which also covered the surveillance of imbalances and monitoring of corrective measures. After growing by 0.9 per cent in 2014, GDP is expected to accelerate by 1.7 per cent in 2015, followed by 1.9 and 2.0 per cent increases in 2016 and 2017 respectively. In 2014 gross domestic product (GDP) grew by 0.9 per cent, in real terms, continuing the gradual economic recovery that had started in 2013. This was characterized by an acceleration in domestic demand and the maintenance of exports as the most buoyant expenditure component. In the first quarter of 2015, according to the first estimate released by Statistics Portugal (Instituto Nacional de Estatística – INE), GDP increased by 0.4 per cent from the previous quarter, growing by 1.4 per cent from the first quarter of 2014 (Chart 2.1). The breakdown of GDP developments into the main expenditure components was only released after the cut-off date for this Bulletin. Nevertheless, based on recent conjectural and qualitative data included in the first estimate published by Statistics Portugal, it is estimated that underlying GDP developments in the first quarter of 2015 will be an increase in domestic demand and a decrease in exports from the previous quarter, which correspond, year on year, to a relative stabilization of domestic demand

growth and the maintenance of strong export growth, higher than that seen in the fourth quarter of 2014. The Portuguese economy's growth in the course of this period is close to the ECB's euro area projections. Portugal is still affected by very high private and government debt, vulnerability of the financial sector due to weak bank profitability and an ongoing deterioration of asset quality, limited access of corporations to credit, high levels of unemployment and bottlenecks in network industries, services, regulated professions and public administration. These weaknesses constitute risks for economic growth and financial stability, thus requiring decisive policy actions. The economic crisis has led to a sharp decline in employment. Although the labor market situation has recently improved, unemployment remains high and the labor market segmented. However, the economy experienced a substantial real wage adjustment in recent years, and Portugal's real effective exchange rate trends are conducive to falling unemployment and the necessary further external rebalancing. Yet there is a risk that unemployment stabilizes at high levels in a low growth environment.¹⁸ General government debt has reached very high levels, also by bringing off-budget operations on record. While the increasing path in gross public debt is expected to reverse in the short term, government debt dynamics remain vulnerable to adverse shocks and impose a high interest burden on public finances. The economic crisis has led to a sharp decline in employment. Although the labor market situation has recently improved, unemployment remains high and the labor market segmented. However, the economy experienced a substantial real wage adjustment in recent years, and Portugal's real effective exchange rate trends are conducive to falling unemployment and the necessary further external rebalancing. Yet there is a risk that unemployment stabilizes at high levels in a low growth environment. Portugal tackled thoroughly its external imbalances but, starting from deep-seated external weaknesses, the rebalancing is still ongoing. The traditionally high structural current account deficit has been closed, exports increased, helped also by improved efficiency and product quality, and the tradable sector gained in importance. However, the net international investment position is still very negative and rebalancing through sustained current account surpluses will not only take time but requires stronger economic growth, higher exports, and more attractiveness for foreign direct investment. Portugal is advancing reforms of the fiscal system. Year-on-year export growth in the first quarter of 2015 reflected acceleration in exports of both goods and services. Developments in exports of goods reflected a strong acceleration in exports of energy goods, year on year, which mirrors the base effect associated with the temporary closing down of an oil refinery unit in the first quarter of 2014. This effect also greatly influenced changes in inventories, which made a highly negative contribution to year-on-year GDP growth in the first quarter of 2015. In turn, exports of non-energy goods decelerated, largely due to a marked fall in

¹⁸ European union, *Country Report Portugal 2015 Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*

exports to Angola, following the oil price decrease and its effect on that country's financing conditions (Chart 2.2). Conversely, more recently, the positive contribution of exports of non-energy goods to EU countries increased. Turning to exports of services, tourism exports continued to grow substantially, year on year, standing at around 15 per cent in the first quarter of 2015, in nominal terms. In the first quarter of 2015, imports increased from the previous quarter, albeit decelerating year on year. This deceleration mainly reflected developments in imports of goods, with year-on-year growth in imports of services remaining relatively stable. Developments in imports reflected the strong decrease changes in inventories, associated with energy goods with high import content, together with buoyant growth in overall demand items with high import content, namely GFCF in machinery and equipment and transport equipment, and durable goods consumption. This applies for strengthening the fiscal framework and implementing new reforms to fight tax fraud and evasion and reforms of the public administration, including at the local and regional level. Initiatives to improve the operating balance of state-owned enterprises continue and renegotiations of several Public-Private Partnerships are near conclusion. The sustainability of state-owned hospitals is being addressed, but their stock of arrears is still high. Portugal is making some progress with structural reforms. In the energy sector, excessive rents and the electricity tariff debt are being addressed. Several infrastructure projects listed in Portugal's long-term transport plan are progressing. Reforms of product markets, services and regulated professions are advancing, although not in a comprehensive way. However, the lack of a systematic approach to monitoring and evaluating reforms makes it difficult to assess their full impact on the functioning of the economy. Decisive measures have been taken to stabilize the financial sector and to overhaul the corporate insolvency and debt restructuring framework. Active Labor Market Policies have been strengthened. The assessment of recent reforms of collective bargaining is mixed, as not all of them promote the alignment of wages and productivity at firm level. No progress has been achieved on strengthening social assistance, including the minimum income scheme. Education and training have undergone important reforms and implementation is now crucial to prove their effectiveness in improving students' performance. Network industries are still facing efficiency and sustainability challenges. Housing, product and services markets reforms are facing delays, especially the full implementation of the European Services Directive. While the competition and regulatory framework is being improved, no progress has been made in reducing the late payment of commercial debts by the administration. Some progress has been made to increase transparency in public procurement and the judiciary.

V. CONCLUSION:

The recovery is projected to strengthen in 2015 on the back of strong external demand, a weaker euro and lower oil prices. After having contracted for three years, domestic

demand has started to rise, and business investment is projected to pick up further in 2016. However, considerable economic slack will remain, as the unemployment rate will continue to fall only moderately. Consequently, the Portuguese economy's net lending should remain stable and the reduction in external indebtedness should be sustained. The pace of growth of private domestic demand should be consistent with the continued deleveraging of private economic agents (households and non-financial corporations). These projections suggest the continuation of the moderate recovery of economic activity that began in 2013, and average growth at a pace close to that projected for the euro area. The growth of the Portuguese economy should be based on sustained robust growth of exports, in parallel with a recovery of domestic demand. This is compatible with external net lending, a fundamental condition for maintaining access to the capital markets under normal conditions. Furthermore, nominal growth projected for GDP and the reduction of the interest rate implicit in the debt, together with the maintenance of a primary surplus, as has been the case since 2013, will contribute to a reduction in public debt from 2015. Higher nominal economic growth, the persistence of historically low interest rates and the existence of positive primary balances will make it possible to start reducing public debt as a percentage of GDP. Finally, projected growth for the Portuguese economy is in line with a gradual decline in the unemployment rate, despite its persistently high levels. Inflation is expected to remain low, but should tend to grow gradually until the end of the forecast horizon, to levels still below projections for the euro area as a whole. As the recovery remains fragile, the more moderate pace of fiscal consolidation is welcome. Further tax reforms, such as an additional, revenue-neutral, reduction in the effective corporate tax rate could strengthen business investment. Further reductions of the high unemployment rate would help to reduce income inequality. Despite progress, the competitiveness of the tradable sectors is held back by weak competition in upstream services sectors, which could be addressed through further structural reforms in the electricity and gas sectors and curbing unnecessary restrictions in professional services. Notwithstanding some progress in deleveraging, reducing still high private sector indebtedness, including through an assessment of the performance of new insolvency procedures, remains a priority for raising bank credit and investment. Reforms have been adopted in order to improve competitiveness, increase flexibility and improve the business environment, but further action is needed in a number of areas. A wide range of reform measures have been adapted to Alleviate nominal rigidities, facilitate adjustment, reduce excessive rents and encourage the reallocation of resources to the tradable sector. Significant measures have also been taken to cut red tape and make the judicial system more Efficient. According to current projections, the Portuguese economy's net lending, measured by the combined current and capital account, will strengthen over the projection horizon, from 2.1 per cent of GDP in 2014 to 3.0 per cent of GDP in 2015 and to 3.2 and 3.4 per cent of GDP in 2016 and 2017, respectively. The evolution of the economy's net lending results from the

combination of an increase in the economy's saving rate and a relative stabilization of the investment rate over the projection horizon. The increase in the current and capital account surplus of 0.9 percentage points (p.p.) of GDP projected for 2015 essentially reflects the increase in the goods and services surplus. This is closely linked to a favorable effect from terms of trade, which was strongly affected by the falling euro-denominated oil price. Furthermore, exports' dynamism ensures that the growth of imports, driven by private consumption and investment, results in the maintenance of the external surplus. In turn, the primary income account deficit is projected to increase, through a reduction in transfers of certain structural EU funds, according to information in the State Budget for 2015. In 2016 and 2017, the goods and services account balance as a percentage of GDP remains at similar levels to 2015. In 2016, the positive volume effect driven by a projected growth in exports slightly higher than the growth projected for imports is offset by slightly unfavorable developments in the terms of trade, in a context of moderately increasing oil prices. A relative stabilization of these effects is projected for 2017. Over these two years, the primary income account deficit should fall, against a backdrop of falling interest rates, given that the surpluses in the secondary income account and capital account should remain relatively stable as a percentage of GDP. However, significant structural weaknesses remain in key areas, including services and regulated professions, public administration and network industries (particularly energy and transport). In addition, robust and systematic monitoring and impact assessment tools are needed to assess the impact of reforms. The national competition and regulatory framework has been improved, but actual implementation must be carefully monitored. Reforms of Portuguese services markets and regulated professions have yet to be completed. For Portugal, the impact of barrier reductions from the implementation of a sub-set of services covered by the Services Directive will increase the overall GDP by 0.8% in line with the EU average. Some important pieces of legislation remained unchanged after the termination of the macroeconomic adjustment program, limited progress has been made in aligning the outstanding sector-specific legislation with the Service Directive and there is no political will to amend legislation on universities. Laws on construction services and copyright collective management societies are delayed in Parliament. In addition, limited progress has been made towards improving access to a number of highly regulated professions. To this end, a framework law reforming professional services governed by professional associations was adopted in 2012 under the program, introducing rules and principles. Work is ongoing, although with some delay, to reduce administrative burden. Authorities are carrying out inventories of the most burdensome regulations and drafting roadmaps to tackle them. Thus we can say that Portugal is on the process of development with all the kinds of policies being adopted by them, still it has a long way to go. Over the last few years, the Portuguese economy has seen significant progress in the correction of certain macroeconomic imbalances accumulated over the last few decades, in particular

the achievement of an external account surplus, directing resources to sectors with greater exposure to international competition and maintenance of the fiscal consolidation process. However, growth potential in the Portuguese economy is still restricted by the need to sustain the reduction of indebtedness in the public and private sectors, by the unfavorable outlook for demographic trends, by the high level of long term unemployment, and by the limited levels of productive capital per employee, after a long period of sharp falls in investment. Against this background, the Portuguese economy should pursue the adjustment process under way, with sustainable increases in consumption, investment growth that ensures the renewal of capital and progressively lower indebtedness levels. The success of the Portuguese economy will depend above all on its ability to increase the quantity and quality of its productive resources, its pursuit of structural reforms that promotes economic growth sustainably and equitably and economic policy decisions that preserve the fundamental macroeconomic balances. The favorable international environment at present is a good opportunity to deepen this agenda in Portugal.

The Euro zone is experiencing a major balance of payments and competitiveness crisis. Recovery in the less competitive Euro zone periphery is constrained by the inability of these countries to restore competitiveness through currency devaluation. Competitiveness can only be restored through a sustained period of lower wage growth and overall inflation in the periphery than in the more competitive regions. However, low inflation in the periphery reduces the nominal growth of GDP making debt sustainability much harder to achieve. But restoring competitiveness to the periphery does not necessarily require low inflation and wage growth in the periphery. Because competitiveness is a relative concept, improved competitiveness in the periphery simply requires lower rates of inflation than those prevailing in the more competitive regions. This suggests the ECB and other European policymakers should broaden the scope of their inflation targeting beyond the headline rate for the Euro zone, and expand their focus to incorporate a system of differentiated inflation targeting, with each regional economy being assigned its own inflation target. As part of this process, the ECB's target inflation rate of 2 per cent for the Euro zone as a whole should temporarily be increased to 4 per cent for a defined period. The Euro zone periphery is approximately one third of the overall Euro zone economy. It can be seen, higher inflation targets for the overall Euro zone clearly make it easier to reconcile improved competitiveness with debt sustainability through higher nominal GDP growth. Higher inflation will lead to a devaluation of the euro which will partially offset some of the competitiveness losses in the core Euro zone countries. The implication is wage and income increases combined with looser fiscal policy in the more competitive economies are a vital element of Euro zone recovery. . The monetary union can fail. But if the correct policies are adopted the Euro zone can also be transformed into a viable structure over the long-term. We must learn the lessons of history as well as the lessons of economic theory. Monetary unions

must be supplemented by banking unions including trans-national deposit insurance. Monetary union requires a guaranteed lender of last resort with safeguards against moral hazard. A centralized fiscal apparatus to help offset regional recessions and asymmetric shocks is also a crucial element of any successful monetary union. Finally, we must consider the type of EMU we want to be part of and the type of EMU we want to save. We must restore social Europe and the EMU must not become a straightjacket that automatically preferences inflation and deficit targets at the expense of unemployment and poverty targets.