The Portuguese Economic Crisis: Policies and Outcomes

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DISCLAIMER: The views expressed are my own, and not necessarily the ones of the Bank of Portugal or the Eurosystem.

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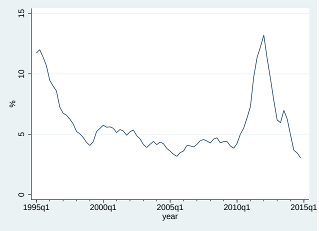
Introduction

"Portugal is in serious trouble. Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large."

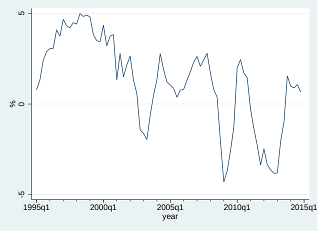
"In the absence of policy changes, the most likely scenario is one of competitive disinflation, a period of sustained high unemployment until competitiveness has been reestablished."

Olivier Blanchard, Portuguese Economic Journal, 2007

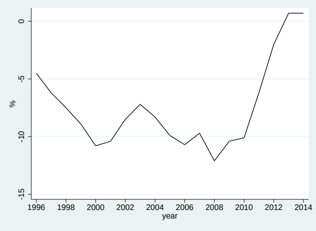
Portuguese macroeconomic imbalances



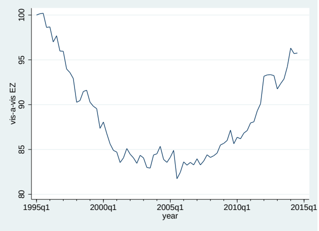
(1) Yield on Government Bonds



(2) Real GDP growth



(3) Current account



(4) Unit Labour Costs (vis-a-vis EZ)

A dysfunctional labor market

Poorly designed labor market institutions, in face of severe economic shocks, can lead to disastrous labor market outcomes

- Extreme employment protection.
- Near-extreme unemployment protection.
- Extreme nominal wage rigidity.
- A wage setting system disconnected from firm specific economic conditions.

Generated

- A sclerotic labor market.
- A chronic productivity problem in the economy.
- A fragmented labor market (insiders and outsiders).

The Memorandum of Understanding (MoU)

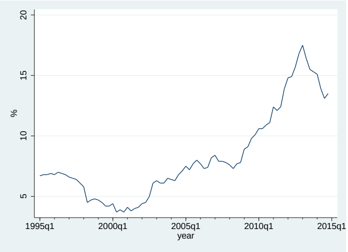
- Challenging budgetary targets were set.
- A significant recapitalization of the banking system was initiated.
- Accompanied by a demanding deleverage of the financial institutions.
- A long and detailed list of structural reforms across all government areas was crafted.
- A substantial fiscal devaluation was agreed.

The program was successful in a number of dimensions

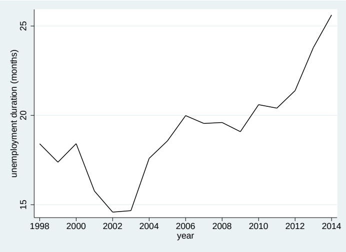
- The economic recession is over.
- Public finances visibly improved.
- Financial conditions stabilized.
- External competitiveness has been gradually reestablished.
- Unemployment rates are finally decreasing.

But the negative labor market consequences of the crisis will persist for some time

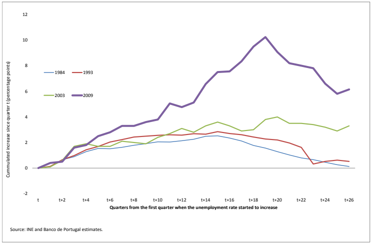
Labour market outcomes



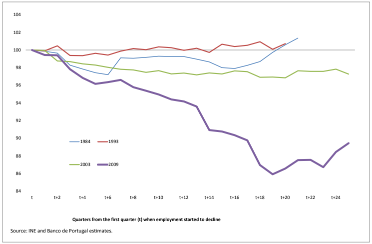
(1) Unemployment rate



(2) Average unemployment duration



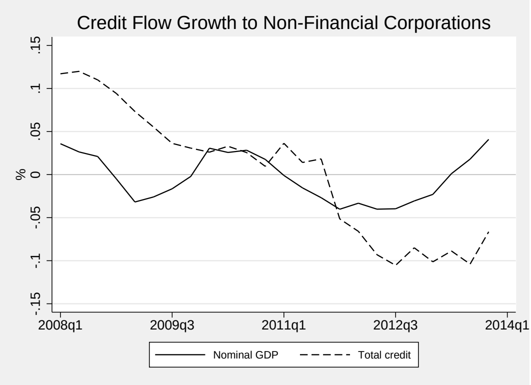
(3) Unemployment rate recovery



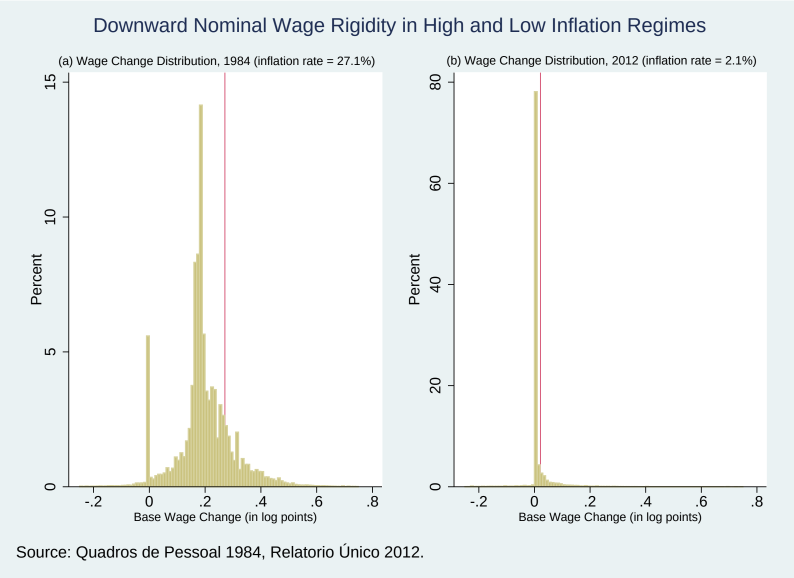
(4) Employment rate recovery

The Credit Channel of Job Destruction

- Portuguese non-financial firms faced severe credit restrictions.
- Interest rate fragmentation across the Euro-zone is also worrying.
- There is suggestive evidence that, during this period, more stringent credit constraints were associated with a higher incidence of firm closures and lower net job creation rates.



Wage rigidity channel



Some Lessons

- A recovery program must include jobs
  The adjustment program, while successful in other dimensions, was disappointing in terms of employment outcomes. The labor market reforms approximated only modestly the Portuguese framework closer to EU mainstream practices.

- Wage-setting systems still need to be reformed
  The praised German experience favoring decentralized mechanisms of wage bargaining should be given serious consideration. However, the Portuguese system of industrial relations is firmly rooted in legislation and overwhelmingly governed by the political process.

- Tax cuts on labor inputs could benefit workers
  The debate on wage adjustments has not valued enough the possibility that labor cost savings can be achieved through means other than nominal wage cuts. In a low inflation environment, fiscal credits on (labor) earned income may prove to be instrumental reducing structural unemployment.

- More support for low wage workers
  A European program subsidizing low wage earners, which also has merits in terms of its desirable cyclical and redistribution properties (e.g., reducing poverty), would make an effective complement of a basic European system of unemployment insurance.