Portugal: Policy for A Sensible Recovery

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Policy Proposals for the Eurozone:

1. Inflate the Euro (around 4%) for the next five years
2. Formulate Eurozone fiscal rules (movement towards a Eurozone fiscal union)
3. Transfer a tranche of Sovereign debt from Eurozone members to the ECB to be held as ECB bonds

Suggestions (Hopes):

4. Establishment of Eurobonds
5. Investment from Sound Economies into the periphery

Policy Proposals for Portugal:

1. Levy current interest payment deductibles to reduce corporate tax rate
2. Maintain fiscal consolidation measures to reduce the national deficit and debt
3. Attract hotel chains for tourism revenue
4. Nominal wage cuts to combat unemployment
5. Job search assistance and monitoring, use training programs to maximize employability gains
6. Reform the education assessment system

Narrative Explanation:

Portugal is currently experiencing high debt (123.5%), unemployment (~15.5%), and downward nominal wage rigidity. In a country with its own currency, monetary measures such as inflation can be taken to reduce the burden of the debt, and lower wages in real terms to help the economy return to full employment. Given the sovereign debt and unemployment situations
in the countries of Greece, Ireland, Italy, Spain, and Portugal.\textsuperscript{1} We recommend that the ECB inflate the Euro at 4\% for the next 5 years to help alleviate the burden on these countries.\textsuperscript{2}

While there are fiscal targets necessary for entry into the European Monetary Union (with some exceptions), there are not long term fiscal rules governing sovereign conduct. There is a monetary union without a fiscal union. This disparity has limited the actions of various countries during this current crisis. A clear outline of fiscal rules requiring sovereign debt to GDP ratios of a certain and deficits of a certain size for Eurozone countries will go a long way towards assuring less fiscal policy disparities seen during the current crisis.

To help facilitate movement by Eurozone countries towards sound fiscal policy, we recommend the ECB to engage in a conditional policy of buying tranches of sovereign debt in exchange for agreed upon changes in fiscal policy. With sovereign debt rated below investment grade in some countries, the ECB can provide much needed liquidity to sovereigns with high interest rates. The ECB currently holds more than 700 billion euros in deposits, so there is no shortage of funds to fuel this program.

A proposed, yet likely unpopular policy would be to create Eurobonds. Countries in the Eurozone suffering from high sovereign interest rates and lack of credit with which to roll over their debt. The high credit rating of countries with strong economies would benefit the junk and barely investment grade ratings of the PIIGS countries. Problem with this strategy lies in the interest rate increase that financially sound countries like Germany will have to take by being included in Eurobonds with countries that currently have high interest rates. The decision comes down to how willing the stronger countries are to help out those in need.

While Greece and other PIIGS countries have done a good deal to precipitate problems with their sovereign debt, the fault also lies in the hands of unscrupulous investors that under
priced the risk of Greek debt leading up to 2010 and the German and French banks who lent money in Spain, which precipitated their housing bubble. As a whole this is a Pan-European problem, and it needs a Pan-European solution. The economic downturn in PIIGS countries associated with troika imposed fiscal austerity need stimulus to encourage recovery. We recommend investment by sound countries in infrastructure and technology to promote economic growth in Europe as a whole.

Currently in Portugal, interest payments are deductible based on accruals. By lowering the interest deductibles, the Portuguese government could use the new revenue to reduce the corporate tax (IRC - with a current possible aggregate of 26.5%). Ideally with a reduction in the corporate tax, firms would increase employment and investment.

It is important to both investors and other EU members to show that Portugal is committed to maintaining fiscal consolidation measures and reducing the national deficit. The Portuguese deficit has already been significantly reduced, but it is important that the austerity measures are implemented on a timeline that does not severely hamper economic activity. The Portuguese government has been diligently working to meet the conditional lending terms of the IMF and ECB.

Hospitality in Portugal is small relative to other Eurozone nations but there is a huge labor productivity gap (44% of the productivity in France). Part of this inefficiency is the limited role of Hotel chains. Part of attracting hotel chains would require seasonal wage adjustments. With the introduction of foreign firms with already established capital, relevant industries outside of tourism (construction, food services, etc.) would also see an increase in profit. Introduction of more hotel chains in Portugal would increase GDP, employment and reduce labor inefficiency in hospitality services.
Although unpopular, forced nominal wage cuts may be required to reduce the current disparity in labor productivity. Currently Portugal is experiencing both nominal and real wage rigidities. A forced wage cut would reduce unemployment and firms would be able to hire more workers.

To effectively allocate the flow of laborers, job search monitoring should increase, with search requirements more appropriately aligned. This should be extended to active labor market participants as well. In addition, there should also be effective sanction enforcement.

Education reform is key to increasing the labor productivity in Portugal. Of the working population (25-64), only 30% have attained upper secondary level education and there is still a large share of youths dropping out with a low level of skill sets.9 Restructuring the education assessment program currently in place, is necessary to allocate educational spending more efficiently. At the national level there needs to be integrated evaluation and assessment framework. The current issue is a consolidation of the information being assessed. Currently there is no systematic linkage of school improvement and school evaluation results. With a more efficient assessment system in place education reform will work more cohesively, and the discrepancies can be better addressed.

Citations:


11 Blanchard, Olivier “Adjustment Within the Euro: The difficult case of Portugal” © Springer-Verlag 2006. Published December 7, 2007