A Memo on the Political and Economic Climate in Portugal as It Concerns the European Sovereign Debt Crisis

John Mills & Dylan McKenna

1. Political History of Portugal:

The current government of Portugal is relatively young. In 1974, the "Carnation Revolution" led to a regime change, allowing for the creation of a democratic republic in 1976, formally known as The Third Republic Democracy. The constitution of 1976 divided the political power into executive, legislative and judicial branches. The legislative body is the Assembly of the Republic and it is unicameral. The president is the head of state and commander-in-chief of the military and has veto power over bills, however the prime minister is chief executive of the Portuguese government. Portugal currently uses a multi-party system consisting of 19 different political parties, though elections are dominated mostly by the Socialist Party (left leaning) and the Social Democratic Party (center-right leaning). Portugal, a member of the EU since 1986, joined the EMU in 1999. Portugal has been using the Euro as its only currency since 2002. Portugal circulated Portuguese Escudo and used the Euro as "book money", from 1999 until the full transition in January and February of 2002.

From 2005 until 2011 the political power rested with the Socialist Party, led by Prime Minister José Sócrates. In March 2011 when his fourth package of austerity measures was rejected by opposition in the Assembly, Sócrates handed his resignation to Aníbal Cavaco Silva who dissolved parliament and called for early legislative elections. Between his resignation and the elections, Prime Minister Sócrates went on national television in April to announce that Portugal was facing bankruptcy and would ask for assistance from the IMF and the EFSF as

Greece and the Republic of Ireland had already done. The legislative elections took place in June 2011 with a low turnout (~60%). The Portuguese voted out the the Socialist Party majority; and the Portuguese Social Democratic Party, of the conservative Popular Party came into power under the leadership of Pedro Passos Coelho as Prime Minister.

In 2011, Prime Minister Passos Coelho appointed Vítor Gaspar as Finance Minister. Gaspar is responsible for the fiscal policy of Portugal and has implemented strict austerity measures and put forth budget proposals slashing government spending and raising taxes.

2. <u>Economic Situation:</u>

Currently Portugal is experiencing economic contraction with one of the highest output gaps between Eurozone countries. Portugal has the smallest per capita GDP in in Western Europe. The year total GDP is estimated to contract 1.6% in 2012. From 2001 to 2010 GDP growth averaged a meagre .6 %.[11] The current account balance of Portugal has increased from -12.4% in 2004 to -17.2% in 2010. Although still a decrease from 21.7% in 2008.[21] The current recession is expected to continue through all of 2013, with an expectation of positive GDP growth 2014.

The ratio of Portuguese public debt to GDP is 114.5% for 2011, and is expected to climb to just over 120% in 2013.[15] Since 2009, Portugal has gotten its GDP to deficit ratio down from 10.2% to 4% in 2011 through the strict financial austerity measures of Finance Minister Vítor Gaspar.[13] In the first quarter of 2012 Portugal saw an increase of 11.6% of net exports and a 3.3% drop in net imports.[22] Sovereign bond ratings for Portugal have also been downgraded recently to just above junk status, and then to junk status (Baa1 and BBB-.), making it more difficult to borrow.[9] In addition, 10-year bond yields have been been as high as 12% in 2012. However, yields have had a downward trend in recent months due to the reduction of the deficit by the Portugal. As of October 23rd yields are on 10-year treasury bonds are 7.78%, putting Portugal in a better, though not ideal situation to borrow.[17] In 2010 the Government spending ratio of the GDP was at 49.3%.[2]

The current unemployment rate in Portugal is 15.9 %, a 1% increase from June of the same year.[1] In 2011 the annual employment change was -2.6% with an expected change of -3.3% for 2012.[20] Youth unemployment is greater than 20 %. In 1975 Portugal introduced the Decreto-Lei 372-A/75 regulating the dismissals of Portuguese workers, using lengthy paragraphs to define definite "cause" for dismissal. Finally in May of 1989 Decreto-Lei 64-A/89 came to pass, slightly loosening the terms under which Portuguese firms could fire employees, but the law had the most impact on relatively small firms.[19] For the past few years, Portugal has been experiencing both real wage rigidities and nominal wage rigidities - the unemployment rate's effect on real wage change is minimal and the nominal wage has not adjusted effectively to prices.[3] Today in Portugal, the labor law forbids "unjustified wage decreases".[3] The proportion of GDP devoted to education in Portugal has tripled from 1.3 % of GDP in the old Regime of 1974, to 5.2 % in 2009. Currently Portugal is ranked fifteenth in spending per student relative to GDP per capita. 93% of the Education expenditures are received by unionized teachers, compared to an average of 74.4% among other OECD nations.[2]

3. <u>Involvement in the Euro Crisis:</u>

In May 2011, the government of Portugal received a bailout €78 billion. After Greece and the Republic of Ireland, Portugal was the third country in the Eurozone to ask for assistance from the troika (European Commission, European Central Bank, and the International Monetary Fund). Conditions of the bailout for Portugal consist of harsh financial austerity measures. Portugal was granted another year to lower its deficit to the target deficit ratio previously agreed upon by ECB. On October 15, 2012 Vítor Gaspar introduced a draft budget with new tax increases, and public sector job spending cuts.[1] The proposal was met by thousands of protesters encircling the Portuguese parliamentary building, increasing nationwide concern about the economic stability of Portugal.[23]

Through the 2000s, wage/GDP growth stagnated in Portugal. In addition, Portugal was highly dependent on foreign debt, as can be seen in their high current account deficit.[25] When Greece, failed Portugal was susceptible to crisis.[25] Because of this, investors bet against Portugal, by raising premiums, thinking Portugal would not be able to finance itself in sovereign debt markets. As the situation worsened across Europe, Portugal's access to foreign lenders was almost entirely cut off. Their bonds were downgraded to junk status and yield rates were raised over 10%.[9] When austerity measures did not pass in parliament, it was clear that a bailout would be needed. Now Portugal is working on implementing ECB targets for deficits and debt and is experiencing fiscal consolidation.

4. <u>Domestic Pressures Limiting Action:</u>

Due to fiscal consolidation, Portugal is experiencing high unemployment and lowered take home pay.[24] Up until very recently, the Portuguese public have been tightening their belts and gritting their teeth to bear the austerity measures. However, there have been peaceful demonstrations of dissatisfaction with the severity of the measures.[23] There is speculation that the public is willing to take only so many more cuts in benefits and wages that they have become accustomed to receiving. There is a potential for civil unrest over the extremely harsh budgetary plan for 2013 put forth by Finance Minister Vítor Gaspar.[23]

Citations:

1. Barrientos, Michael “Topic: Portugal” *The New York Times,* updated October 15, 2012 http://topics.nytimes.com/top/news/international/countriesandterritories/portugal/index.html?8qa
2. Bragues, Georges “Portugal’s Plight: The Role of Social Democracy” *The Independent Review*, Winter 2012 (325-349)
3. Blanchard, Olivier “Adjustment Within the Euro: The difficult case of Portugal” © Springer-Verlag 2006, Published December 7, 2007
4. Carlos Pereira and Shane Singh, “Economic Performance and Political Coordination in Portugal’s “Dry” Political System” Michigan State University, February 10, 2009
5. “Country Statistical Profile” OECD, published January 18, 2012, http://www.oecd-ilibrary.org/economics/country-statistical-profile-portugal_20752288-table-prt
6. “Economic and Financial Affairs: Portugal” European Commission, Last modified July 12, 2012 http://ec.europa.eu/economy_finance/eu/countries/portugal_en.htm
7. Fidler, Stephen “A Golden Solution for Europe’s Sovereign Debt Crisis” *The Wallstreet Journal,* October 20, 2012 http://online.wsj.com/article/SB10000872396390444734804578064660899712092.html
8. “Gaspar, Vítor “Third Review of the Economic Adjustment Plan for Portugal Indroductory Statement by the Minister of State and Finance” Portugal Government , February 28, 2012 http://www.portugal.gov.pt/media/520312/20120228_mef_revisao_paef_ing.pdf
9. Joao Lima and Jim Silver, “Portugal’s Credit Rating is Cut to Junk by S&P on Euro Crisis” *Bloomberg Businessweek,* January 15 2012, accessed October 2012, http://www.businessweek.com/news/2012-01-15/portugal-s-credit-rating-is-cut-to-junk-by-s-p-on-euro-crisis.html
10. Marques, Carlos Robalo “Wage and Price Dynamics In Portugal” *European Central Bank Working Paper Series,* Banco de Portugal, October 2008, http://www.ecb.int/pub/pdf/scpwps/ecbwp945.pdf
11. Pina, Á. and I. Abreu (2012), “Portugal: Rebalancing the Economy and Returning to Growth Through Job Creation and Better Capital Allocation”, OECD Economics Department Working Papers, No. 994, OECD Publishing. http://dx.doi.org/10.1787/5k918xjjzs9q-en
12. “Portugal Economic Freedom Score” The Heritage Foundation, Last modified 2012, http://www.heritage.org/index/country/portugal
13. “Portugal Country Report” Global Finance Magazine, Last modified June 12 2012, http://www.gfmag.com/gdp-data-country-reports/196-portugal-gdp-country-report.html#axzz2AHpfE21a
14. “Portugal and the Euro” EUbusiness, Last modified February 2008, http://www.eubusiness.com/topics/euro/portugal-and-the-euro/
15. “Portugal Economic Forecast Summary” OECD, Last modified May 2012, http://www.oecd.org/portugal/portugal-economicforecastsummarymay2012.htm
16. Sivy, Michael “Why Portugal May Be the Next Greece” *Time: Business and Money,* March 27, 2012 http://business.time.com/2012/03/27/why-portugal-may-be-the-next-greece/
17. “Snapshot for Portuguese Government Bonds 10 Year Note: Portugal” Bloomberg, Last modified October 25, 2012 http://www.bloomberg.com/quote/Gspt10yr:IND

18. “Unemployment in Europe” Data from Eurostat, Last modified October 24, 2012
http://www.google.com/publicdata/explore?ds=z8o7pt6rd5uqa6_&met_y=unemployment_rate&idim=country:pt&fdim_y=seasonality:sa&dl=en&hl=en&q=unemployment+rate+portugal#!ctype=l&strail=false&bcs=d&nselm=h&met_y=unemployment_rate&fdim_y=seasonality:sa&scale_y=lin&ind_y=false&rdim=country_group&idim=country:pt&idim=country_group:eu&ifdim=country_group&hl=en_US&dl=en&ind=false

19. Martins, Pedro S. “Dismissals for Cause: The Difference That Just Eight Paragraphs Can Make” *Journal of Labor Economics* , Vol. 27, No. 2 (April 2009), pp. 257-279, Published by: The University of Chicago Press on behalf of the Society of Labor Economists and the NORC at the University of Chicago, http://www.jstor.org/stable/10.1086/599978

20. “European Economic Forecast: Spring 2012,” last modified January 2012, http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-1_en.pdf.

21. Balance of Payment Statistics” European Commission Eurostat, last modified November 2011, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Balance_of_payment_statistics

22. Wise, Peter “Export growth boosts Portugal’s Prospects” *Financial Times*, May 28, 2012

23. “More Pain, Less Gain,” *The Economist,* October 20th, 2012, http://www.economist.com/news/europe/21564902-yet-another-austerity-budget-raises-concerns-about-future-growth

24.”The Tipping Point,” *The Economist,* September 22nd, 2012, http://www.economist.com/node/21563352

25. Alessi, Christopher “The Eurozone in Crisis” *Council on Foreign Relations* updated July 23, 2012
http://www.cfr.org/eu/eurozone-crisis/p22055

http://www.peprobe.com/library/we-suggest/news-a-facts/4648-press-review-social-sentiment

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1991159

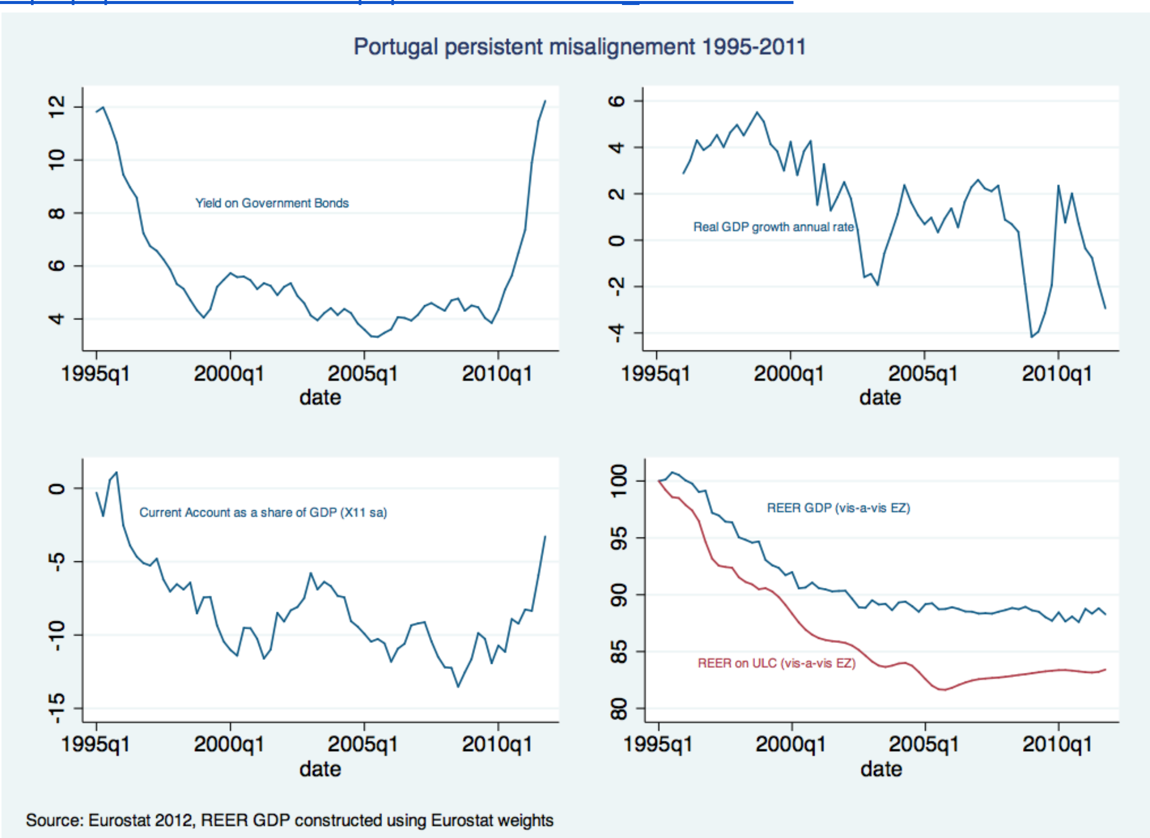
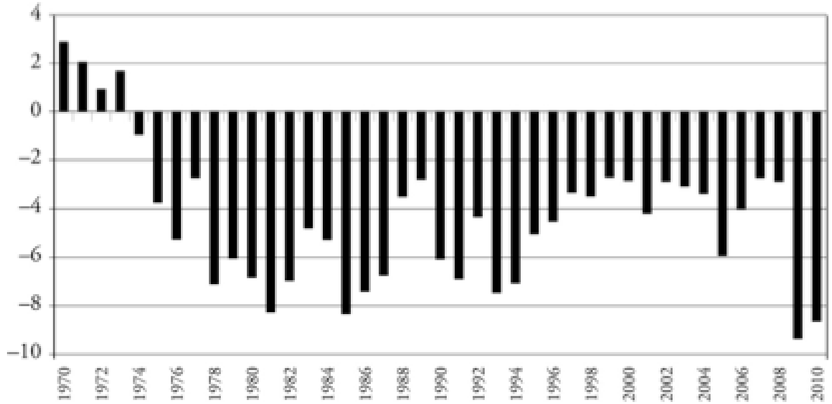


Figure 9
Annual Portuguese Government Budget Balance as a Percentage of GDP, 1970–2010



Source: From data in Bank of Portugal 2011.

Figure 3
Portuguese Government Spending as a Percentage of GDP, 1970–2010

Sources: From data in Valério 2001; Bank of Portugal 2011; European Commission 2011.