Kiel Policy Brief

Will Portugal Turn into a Second Greece?

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No. 42 | March 2012

Institut für Weltwirtschaft Kiel
Kiel Institute for the World Economy

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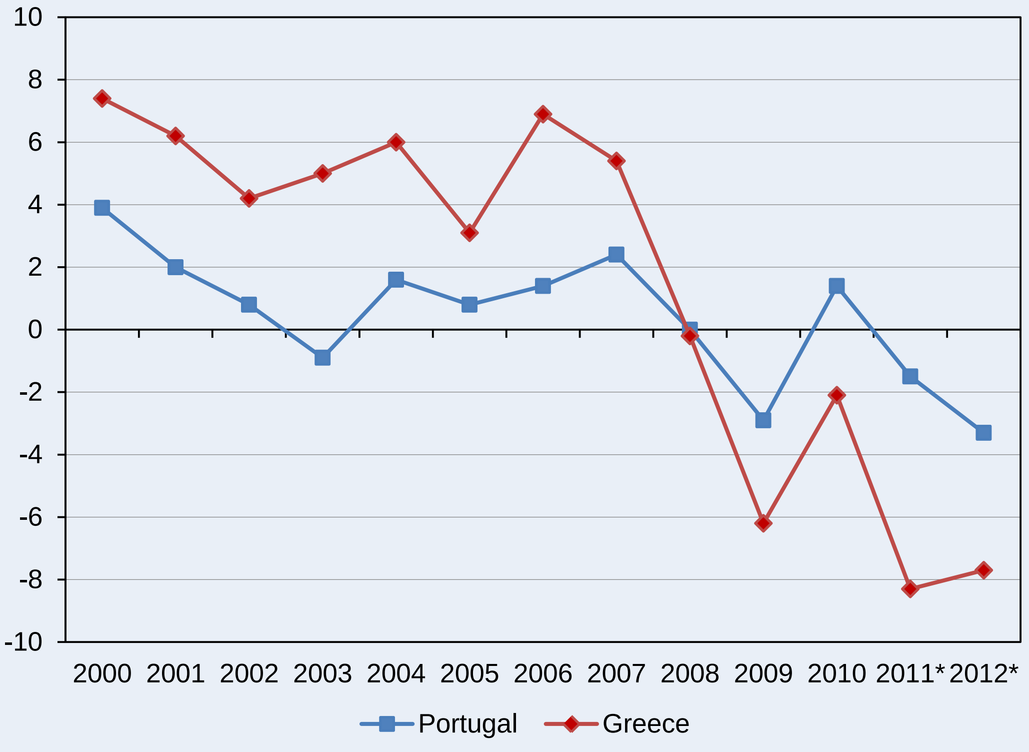
Current economic developments in Portugal do not portend well. The Portuguese GDP is shrinking and the growth forecast for 2012 is gloomy — in the EU only the forecast for Greece is even worse (Figure 1). Moreover, Portugal is now having to pay double-digit interest rates on its bonds, its debt ratio exceeds 100 p.c. of GDP, its unemployment rate is knocking on 15 p.c., and its current account deficit continues to remain high. All of these things not only indicate that Portugal is in a serious economic crisis. They also conjure up parallels to Greece's economic plunge. Thus, it is not surprising that many expect that Portugal will turn into a second Greece.

But is this expectation really well founded? We think the answer to this question is no. A careful analysis of the crisis in Portugal shows that it is different from the crisis in Greece. Portugal has a better chance of avoiding economic collapse than Greece.

Figure 1:
Economic Growth in Portugal and Greece 2000–2012[a]



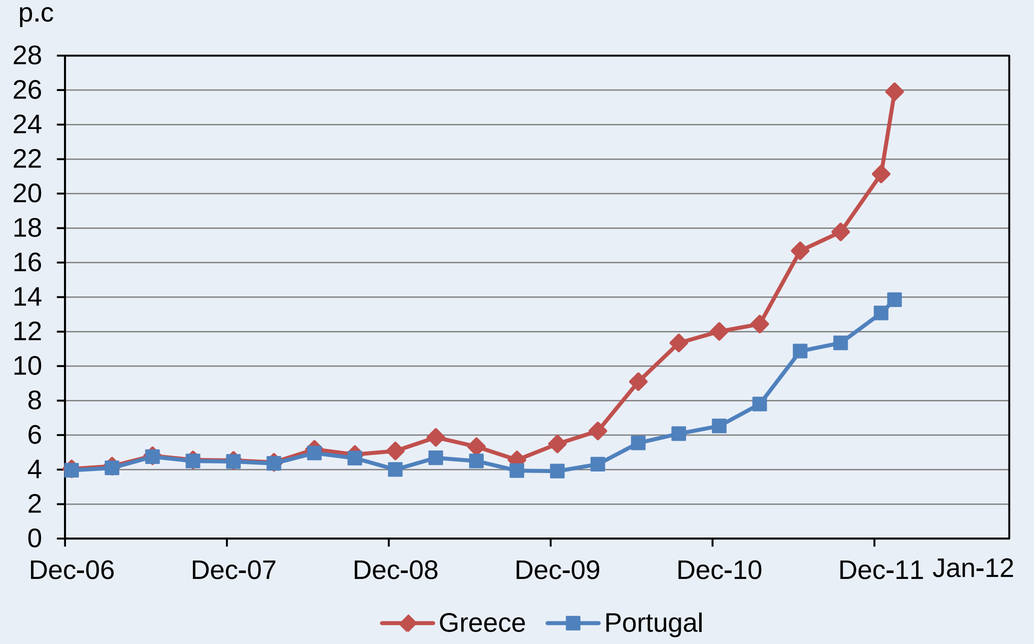
[a]Percentage change of GDP, volume. — *Estimates for 2011 and 2012 by the European Commission (2012).

Source: **Eurostat (2012a); European Commission (2012); own compilation.**

Causes of the Crises

Portugal is now having to pay interest rates of close to 15 p.c. on its bonds (Figure 2). The fact that Portugal's budget deficit developed in a similar way as Greece's deficit has caused such a loss of confidence in Portugal that in 2011 it has had to ask EU and IMF for aid in order to avoid going bankrupt.

Figure 2:
Long-term Interest Rates for Portuguese and Greek Government Bonds 2006–2012[a]

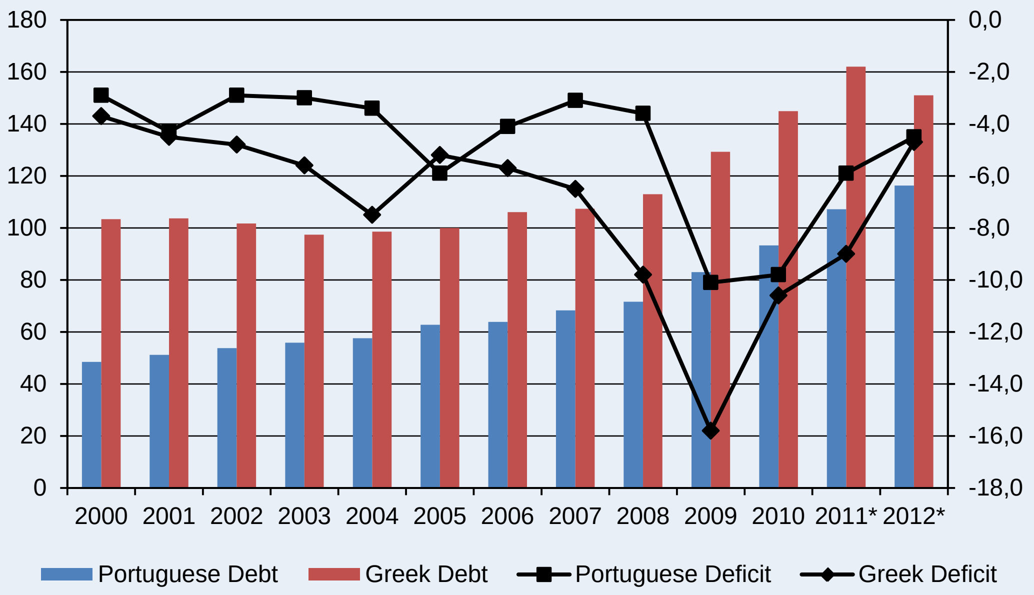


[a]Interest rates for government bonds with a term of 10 years until January 2012.

Source: **ECB (2012), own compilation.**

How could it come to this? Portugal, unlike Greece, has not pursued policies that quickly racked up excessive debt. It has become highly indebted in a long drawn out process that has taken it ever farther away from the Maastricht budget deficit and debt criteria. As a result of the worldwide financial and economic crisis, its debt has exceeded a critical threshold and has become unmanageable (Figure 3). On top of this, Portuguese private households and companies have traditionally held a great deal of debt, and Portuguese banks hold a relatively high amount of foreign debt (Figure 4). But it has to be noticed, that in contrast to Greece the need for aid did not gain momentum and the compulsory austerity measures went rather smoothly. Hence, the positive testimony by the troika in November last year was not surprising (IMF 2011a). The troika's recommendation in February this year to pay the next tranche of the 78 billion Euro aid programme is in line with these findings.

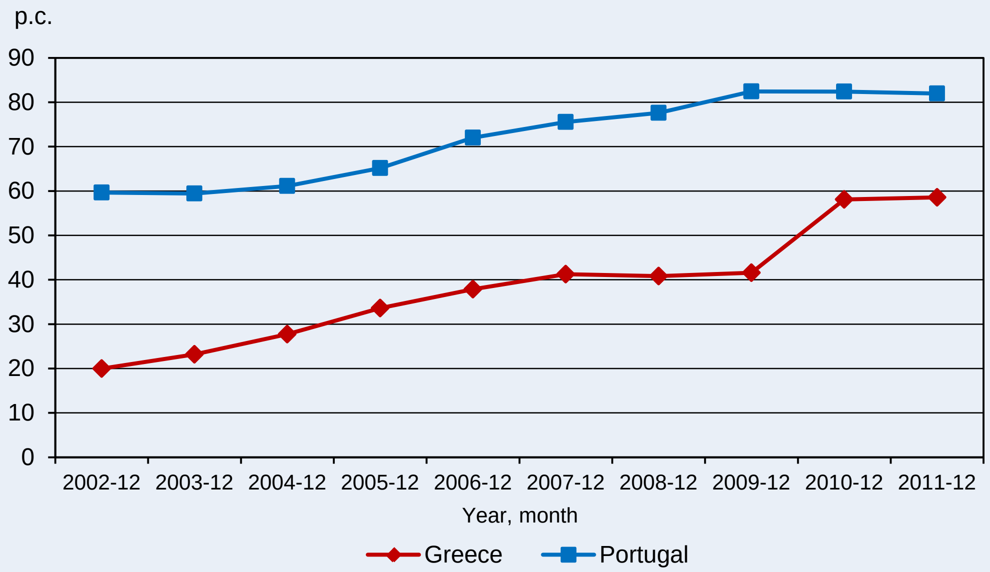
Figure 3:
Budget Deficit and Public Debt in Portugal and Greece 2000–2012[a]



[a]Budget deficit under the excessive deficit procedure and government consolidated gross debt as p.c. of GDP. — *Estimates by the IMF (2011a,b) in December 2011.

Source: **Eurostat (2012b); IMF (2011a, b); own compilation.**

Figure 4:
Private Households Debt in Portugal and Greece 2002–2011[a]



[a]Private households debt in p.c. of GDP.

Source: **Deutsche Bundesbank (2012); Eurostat (2012a); own compilation and calculations.**

Nevertheless, analyses have shown that Portugal will not be able to keep its debt at current levels unless it can achieve large budget surpluses. It would need to achieve budget surpluses that, excluding interest payments, would probably have to exceed 10 p.c. of its GDP (see Bencek and Klodt 2011). Thus, it remains indispensable to implement austerity measures in the years ahead. In doing so, Portugal may have the advantage of being able to establish a domestic consensus about the need to make cuts without having to engage in a lengthy public debate, which has so far made it easier to "quietly" implement austerity measures. Its total debt is also still only two thirds of Greece's, i.e. it is easier to regain control over the Portuguese debt burden.

But it will be even more necessary to generate economic growth, as economic growth would generate revenues, which would, in turn, improve Portugal's credit standing and thus reduce its interest burden. This leads to the question: What are the chances that Portugal's real economy could grow quickly?

They are better, at least, than the chances that Greece's economy could do so. In contrast to Greece, Portugal has not to adopt a new growth philosophy. It has just to draw on the growth story of the 1980s and the early 1990s. During Portugal's integration into the EU in the 1980s, it was able to compete very well for companies to locate there. Because labor costs in Portugal were so low, other Western European countries were actually afraid that companies operating within their borders could outsource production, especially labor-intensive production, to Portugal. Thus, Portugal has a larger industrial base. However, it failed to effect the structural change necessitated by the opening up of Central and Eastern Europe and by globalization. Cheap wages in Eastern Europe and Asia turned Portugal's focus on labor-intensive production into a disadvantage. Portugal failed to make itself attractive for companies that produce human-capital-intensive products rather than products requiring merely cheap labor.

A factor intensity analysis of Portuguese sectoral trade patterns and international competitiveness corroborates these shortcomings: A shift towards technologically advanced products —so called Schumpeter-products[1]— did not take place. Labor intensive products still comprise of close to 40 p.c. of Portuguese exports with a highly positive RCA value signaling Portugal's comparative advantage (Table). Unfortunately, this kind of specialization does not promise the high growth rates necessary to justify an income level at the EU average. It is only a cold comfort that Greece's export patterns are even less promising —instead the German patterns are the better benchmark. Against this background, it is not surprising that in Portugal's industry as well as in its trade— and tourism-dominated service sector there are not enough jobs for highly skilled and remunerated labor. The failure to make structural adjustments is still impacting on Portugal's economic development and is part of the reason for the crisis unfolding there.

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[1] Schumpeter-products are split into products of mobile and immobile Schumpeter-industries with the feasibility of separating research and production spatially as the selection criterion. In the case of mobile Schumpeter-products this separation is feasible because complementary relations between research and production are limited.

Table:
Foreign Trade Patterns and international Competitiveness of Greece and Portugal in Comparison with Germany According to Factor Intensities[a,b] 2005–2009

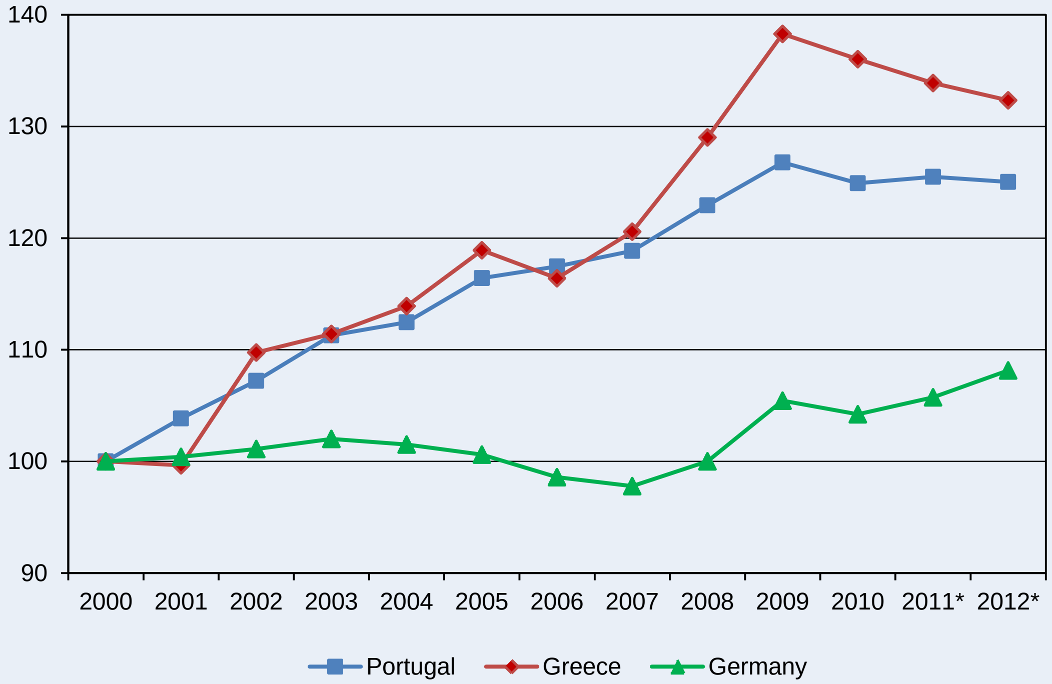
	Portugal	Greece	Germany
Raw material-intensive products			
Exports	18,1	32,9	9,7
Imports	30,4	28,4	27,5
RCA	–0,53	0,16	–1,04
Labor-intensive products			
Exports	38,8	22,0	17,3
Imports	21,1	18,1	18,4
RCA	0,61	0,20	–0,06
Capital-intensive products			
Exports	10,8	18,6	9,3
Imports	10,1	14,1	9,9
RCA	0,07	0,29	–0,06
Mobile Schumpeter-products			
Exports	13,5	8,4	20,0
Imports	14,5	11,4	19,7
RCA	–0,07	–0,31	0,02
ImmobileSchumpeter-products			
Exports	18,8	18,1	43,7
Imports	23,9	27,9	24,6
RCA	–0,24	–0,43	0,58

[a]In per cent of total exports or total imports (special trade) on the basis of revised data of Eurostat (2010) as far as classified on SITC; averages for the years 2005–2009. — [b]RCA-values for commodity group *i* have been calculated by virtue of the following formula: $RCA_i = \ln[(Export_i : Import_i) : \sum Export_i : \sum Import_i)]$; positive RCA-values indicate competitive advantages; assignment based on SITC 3 (cf. Appendix: Box).

Source: **Eurostat (2010); own compilation and calculations.**

Portugal's failure to focus on human-capital-intensive products has gone hand in hand with a decline in its ability to compete internationally. Unit labor costs have risen faster in Portugal since the 1990s than in other European countries, thus making Portugal less competitive. Until the economic and financial crisis the permanent rise of Portuguese unit labor costs did not differ so much from the Greek development. However, in Portugal during the last four years the rise of unit labor costs slowed down unlike Greece (Figure 5). However, an adequate benchmark for competitive unit labor costs in the EU is Germany whose moderate development relentlessly discloses Portuguese persistent shortcomings.

Figure 5:
Development of Unit Labor Cost in Portugal and Greece Compared to Germany 2000–2012[a]

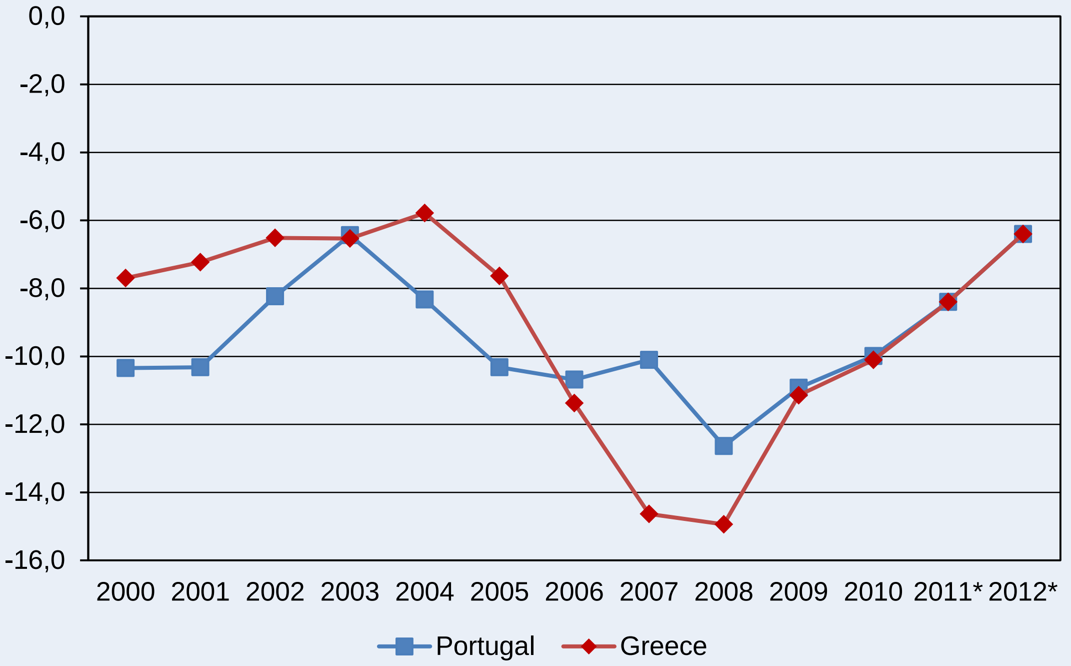


[a]Index, 2000 = 100; nominal unit labor cost defined as: ratio of total compensation of employees per total number of employees divided by the ratio of GDP in market prices in millions, chain-linked volumes, reference year 2005, per total number of persons employed. — *Estimates for 2011 and 2012 by Eurostat.

Source: **Eurostat (2012a); own compilation.**

Of course, wages in Portugal are only 75 p.c. of what they are in Greece. And average wages in Portugal are even less than two-thirds of average wages in the neighboring country Spain. But both countries cannot be used as benchmarks for labor-intensive production. The benchmark countries for labor-intensive production are in Eastern Europe and Asia, and Portugal cannot compete with these countries price-wise. Even if Portugal could decrease its unit labor costs, it is doubtful whether it could compete with emerging economies in producing cheap, standardized, labor-intensive products requiring low-skilled labor. Although Portugal is one of the poorest countries in the EU, only in most of the Eastern European EU countries the per capita income is lower, it simply cannot win a race to the bottom. Portugal can only gain a competitive advantage by increasing its productivity and the quality of its products and services. This process may be eased by the fact that it is, at least to some extent, integrated into international production networks that produce technology-intensive products — something that Greece is not.

Figure 6:
Current Account Deficits of Portugal and Greece 2000–2012[a]



[a]In p.c. of GDP. — *Estimates by the IMF (2011a,b) in December 2011.

Source: **Eurostat (2012a); IMF (2011a, b); own compilation.**

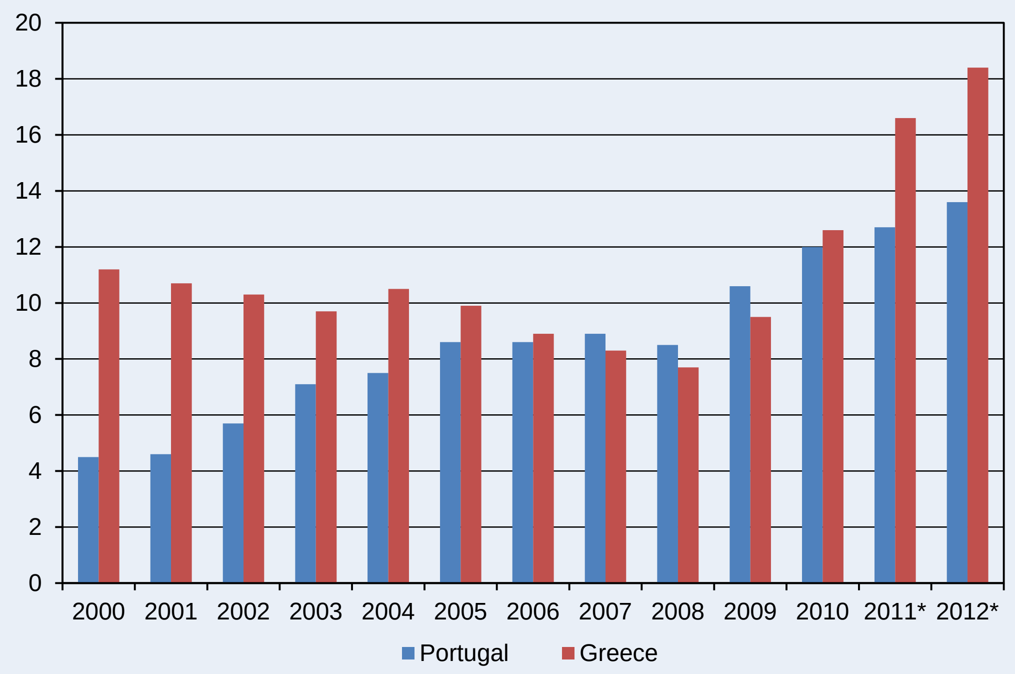
Becoming more competitive internationally is the key to resolving Portugal's current account problem: its current account deficit peaked to more than 12 p.c. of GDP after the introduction of the euro (Figure 6). By regaining its export strength, it could reduce this deficit, whose primary reason is Portugal's high trade deficit. Its trade deficit did decline during the crisis in 2009, but only because imports declined markedly. Recently, however, the trade deficit has finally decreased due to an increase in exports, which is essential for Portugal's perspective to generate growth again. The problem remains, however, that Portugal still exports less than the EU average and thus cannot profit enough from a recovery in world trade. To be sure, Greece is even worse off in this respect, due to its again much lower export intensity.

Portugal, like Greece, has a balance of services surplus, which offsets its trade deficit to some extent. Like Greece, Portugal's service sector provides mainly tourism and transport services, but, unlike Greece, it also provides a large range of business services. Nonetheless, Portugal's potential for growth is in its goods export sector and not in its service sector, and thus it cannot be expected that its service sector will be able to resolve its current account problem.

Portugal's trade in goods could be more dynamic if it intensified trade with dynamically growing countries, such as the BRIC countries or the Asian and Latin American emerging economies. In this respect, Portugal is similar to Greece which also exhibits weak economic ties with the world's fastest growing regions. In 2010 the BRIC export shares were 2,7 rsp. 3,7 p.c. of total export. In contrast to Greece, Portugal's trade with the EU-15 countries is more intensive, although its special trade relation with Spain distorts its regional trade pattern (26 p.c. of Portuguese exports in 2010).

Another reason for Portugal's structural crisis is its labor market. Its labor market regulations impede a sustainable increase in employment. They do not provide adequate incentives to work: almost as much income can be obtained from social transfer programs as from low-paid work. Nor do they provide workers with enough opportunities to upgrade their skills. Further, wages in Portugal, which are generally much lower than wages in Greece, were not productivity oriented during the last decade. Although Portugal is still better off than Greece, whose accelerating unemployment is approaching to a rate of 20 p.c., the unemployment rate in Portugal has also reached double digits and is thus not only alarming but a sign that urgent action has to be taken (Figure 7).

Figure 7:
Unemployment Rate in Portugal and Greece 2000–2012[a]



[a]Harmonized unemployment rate in p.c. — *Estimates for 2011 and 2012 by European Commission (2011).

Source: **Eurostat (2012c); European Commission (2011); own compilation.**

Given the fact that Portugal has failed to effect necessary structural change, it is not surprising that it was one of the most slowly growing countries in the EU in the 2000s. From a current perspective, it might be Portugal's advantage that it avoided excessive consumption as well as generating a real estate bubble. Nevertheless, Portugal now needs export-led growth to overcome its sclerosis. The key to compensate Portugal's lack of competitiveness are structural reforms in order to restore the momentum of the 1980s.

Necessary Structural Reforms

The main objective of all reform efforts in Portugal should be to become internationally competitive again because the only way it will be able to sustain its debt and prevent income levels from plummeting is to generate export-driven growth. To accomplish this, Portuguese reforms should give high priority to making the workforce competitive again.

Portugal's comparative advantage was for many years its competitive labor costs, which attracted labor-intensive production. This advantage has, however, obviously evaporated, as witnessed by Portugal's rising unit labor costs and rising unemployment. Portugal thus needs to increase its productivity. It could accomplish this by effecting more flexible labor market regulations, for example, by loosening up job dismissal regulations, by extending working hours, and by doing away with legal holidays. It could also increase employment by decentralizing wage negotiations and taking productivity at the company level into account. Further, it could lower the minimum wage, as the minimum wage is often a barrier to employment.

Portugal also needs to make its labor market more flexible in order to be able to produce goods and services of a higher value. Portuguese companies are very often not active in the high-growth rsp. high-value sectors, but primarily in the low-value sectors. Portugal needs to change this by, for example, investing in training and education, by drastically reducing bureaucracy, and by marketing itself as a location for high-tech production. Only if it accomplishes this, it will be able to attract high-value production that is part of global industrial value-added chains. In the service sectors, for example in the tourism sector, it also needs to improve value by providing investment incentives.

In addition to large-scale investments at all levels of education, Portugal has to adopt active labor market policies. Primarily, it needs to tackle one of its labor market's main problems, namely the low-skills of the youth and the long-term unemployed, by providing better training programs. A subsidy scheme, including training vouchers for the unemployed, could give complementary incentives to the companies to contribute to the "upgrade" of the Portuguese workforce. Rather than financing unemployment, the government could cut unemployment benefits in order to finance such programs. By cutting unemployment benefits, it would also provide people with additional incentives to work.

Portugal could also increase its productivity by promoting competition. Like in Greece, government activities and privileges in Portugal have kept markets closed and prevented competition. Portuguese markets, in general, thus need to be opened up to domestic and foreign competitors. The measures Portugal intends to implement, namely opening up markets, diminishing government influence, and expanding the powers of the competition authority, are steps in the right direction. But simpler approval as well as streamlined administrative and legal procedures would also help competitors to enter Portuguese markets. Reducing the government's regulatory functions would, by the way, bring about a smaller government that would not need as many employees as today.

Portugal also needs to have less direct government control over the economy. The Portuguese government must no longer act as an entrepreneur. Privatizing state-owned enterprises would obviously increase productivity. However, it is doubtful whether the government's privatization plans will meet this objective any time in the near future. The government's hope to get a better price for the state-owned enterprises try delaying privatization steps is very questionable. Moreover, the idea that the government should first increase the profitability of the state-owned enterprises before privatizing them is absurd. It is precisely the government's failure to increase the profitability of the state-owned enterprises in the past that demands privatization now.[2]

Conclusions

Real economic analysis shows that Portugal is in a better position than Greece to overcome its crisis on its own. The Portuguese government will, however, have to introduce effective deregulation measures and to use scarce public budgets for human capital formation to make Portugal more attractive for high-value production. Austerity measures alone will not be enough. Portugal once again has to become the first choice of investors. It needs to encourage entrepreneurial activities and increase the profitability of investing in the real economy by deregulating the Portuguese economy. This is the only way to generate the growth prospects that will convince people to accept the inevitable hardships that restructuring will incur. There is no evident alternative to the cornerstones of reform sketched out above. Portugal cannot continue to borrow, and it is not likely to receive generous aid packages from the EU.

In summary, Portugal, unlike Greece, does not need to come up with a completely new growth philosophy. Rather, it needs to revive its earlier policy of being internation-

[2] For an overview of structural reforms needed in Portugal see IMF (2011c: 46–60).

ally competitive. A competitive economy, such as Germany which is currently setting the standard for productivity and global integration, should be Portugal's benchmark.

Comprehensive Study (in German):
Schrader, K., and C.-F. Laaser (2012). Die Krise in Südeuropa oder die Angst vor dem Dominoeffekt. Griechenland, Portugal und Spanien im Krisentest [Domino Effect in Southern Europe? Subjecting Greece, Portugal, and Spain to a Crisis Test]**.** Kieler Diskussionsbeitrag 500/501.

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Appendix

Box:
Assignment of Commodities according to Standard International Trade Classification (SITC) to Commodity Groups of Specific Factor Intensities[a]

Commodity groups	Commodity division no. according to SITC rev. 2
Raw-material-intensive products	0, 2 except 26, 3 except 35, 4, 56, 57
Labor-intensive products	26, 6 except 62, 67, 68, 8 except 87
Capital-intensive products	1, 35, 53, 55, 62, 67, 68, 793
Mobile Schumpeter-prodcuts	51, 52, 58, 59, 75, 76, 77
Immobile Schumpeter-products	54, 71, 72, 73, 74, 78, 791, 792, 87

[a]The assignment scheme originally is based on SITC rev. 2 and has been converted to SITC rev. 3.

Source: Klodt (1987), Heitger et al. (1992: 43 ff.), Schrader (1999: 251); own compilation.

Imprint

Publisher:	Kiel Institute for the World Economy Hindenburgufer 66 D – 24105 Kiel Phone +49 (431) 8814–1 Fax +49 (431) 8814–500
Editorial team:	Margitta Führmann Helga Huss Prof. Dr. Henning Klodt (responsible for content, pursuant to § 6 MDStV) Dieter Stribny

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