

## Address given by Pedro Solbes on the challenges facing the Portuguese economy (Santa Maria da Feira, 28 March 2003)

**Caption:** Invited to attend a conference on strategies for the revival of the Portuguese economy, held on 28 March 2003 in Santa Maria da Feira, Pedro Solbes, Member of the European Commission with special responsibility for Economic and Monetary Affairs, delivers an address on the challenges facing the Portuguese authorities, in particular macroeconomic stability and structural reforms.

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**Pedro Solbes**

Member of the European Commission responsible for Economic and Financial Affairs

## **The challenges facing the Portuguese economy**

Conference on "Strategies to re-launch the Portuguese economy"

**Santa Maria da Feira, Portugal, 28 March 2003**

Prime Minister, Ladies, and Gentlemen,

### **Introductory remarks: the twin concern of stabilisation and growth**

I would like to begin my intervention by thanking the organisers of this conference for having invited me to discuss on the challenges facing the Portuguese economy. This subject is without question very topical and interesting.

Let me start by the end and put the main messages of my talk in a nutshell. In my opinion, the major challenges facing the Portuguese economy are:

First, restoring the sustainability of financial positions, including the government sector, and

Second, reinforcing the growth potential of the economy.

Both challenges require the strengthening of the growth potential through the implementation of a comprehensive programme of structural reforms, in conjunction with greater reliance on the external sector and less on domestic demand.

Encouraging steps in this direction have already been taken in 2002. Although some progress has already been achieved in correcting the macroeconomic imbalances much remains to be done still.

### **Reasons for monitoring fiscal policy**

Although for presentation purposes I am going to discuss these two challenges separately, let me stress that economic stabilisation and sustainable economic growth are not independent, nor are they substitutes. Achieving and maintaining budgetary positions close to balance or in surplus is an important component of a stable macroeconomic environment, which would favour all forms of investment (e.g. physical, human, and R&D), providing for high growth on a sustainable basis.

### **Lessons to be learned in the case of Portugal for not having secured a stable macroeconomic environment during good times**

The more recent developments in the Portuguese economy are a clear evidence of the importance of pursuing stability-oriented macroeconomic policies. Had Portugal already attained a sound budgetary position, it could now make unrestrained use of the automatic stabilisers. Instead, economic policy has to be oriented to regain macroeconomic stability, thereby setting the conditions for sustained strong growth over the medium-term.

### **The rapid reaction of the Portuguese authorities to the budgetary slippage of 2001**

The full extent of the budgetary slippage of 2001 was only identified in June 2002. With a deficit estimate of 4.1% of GDP in 2001, the European Commission initiated the Excessive Deficit Procedure (EDP) for Portugal, which led to the Council's decision on 5 November 2002 that an excessive deficit existed in Portugal.

The Portuguese authorities having realised that the budgetary situation was developing less favourably than initially foreseen introduced a rectifying budget, including saving measures worth about 0.6% of GDP. Later on a number of one-off measures were implemented with a view to bringing the deficit below 3%. As a result, the government deficit for 2002 is currently estimated by Eurostat at 2.7% of GDP and at 2.6% by the Portuguese authorities.

Whatever the final figure is, the relevant fact for the point I want to make is that the government deficit target of 2.8% of GDP for 2002 was therefore met. This reflects the firm commitment of the Portuguese authorities to correct the excessive deficit as soon as possible with a view to regaining policy credibility, and preserving the political momentum towards budgetary consolidation. This is a remarkable achievement, which deserves due credit, given the difficult conditions under which it was obtained. We should also note with satisfaction the progress made over the last year in terms of detail and transparency of the government accounts data.

### **The budgetary outcome for 2003 is central for the success of the current consolidation strategy**

However, the budgetary adjustment must be confirmed in 2003. This year is central for the successful implementation of the budgetary consolidation strategy. According to budgetary plans, the deficit ratio is projected to decline by 0.3 percentage point of GDP in 2003: From 2.7% in 2002 to 2.4% in 2003.

There are basically two major risks associated with the macroeconomic outlook for the current year. First, economic growth in the short-term might turn out weaker than projected, following a delay in the economic recovery, particularly in Europe. Second, economic confidence in Portugal, which was already at a very low level before the heating up of the Iraq conflict, may further deteriorate in the coming months, thereby also delaying the recovery.

### **The budgetary consolidation strategy over the medium-term**

The medium-term budgetary consolidation strategy as defined by the Portuguese government in the latest update of the stability programme. From 2004 onwards, budgetary consolidation is to be achieved through a sustained and significant reduction in the primary expenditure expressed in percentage point of GDP. This should be the result of a vast programme of structural reforms bearing fruit, together with rigorous restraint on government consumption expenditure, especially as regards the compensation of government employees. This is expected to lead to an underlying budgetary position close-to-balance by 2006, while at the same time offsetting the revenue losses caused by a substantial lowering in corporate taxes, which are planned to be phased-in over a number of years in order to strengthen the international competitiveness of the economy.

This brings me to discuss the importance of structural reforms, which are essential to pursue the correction of the still large macroeconomic imbalances in the Portuguese economy, and to raise productivity growth.

### **The importance of structural reforms to secure the sustainability of public finances**

In the light of ageing populations, structural reforms in many areas are necessary to secure the long-term sustainability of public finances. In my view, with ageing related spending ratios rising faster in Portugal than in the rest of the EU, a thorough implementation of the comprehensive structural reforms programme envisaged in the latest stability programme update is necessary, particularly in the areas with a direct impact on budgetary consolidation, notably in the public administration, education, and healthcare. Furthermore, the dynamics of pensions expenditure in recent years, including 2002, together with the additional pressure on expenditure resulting from the planned convergence of minimum pensions towards the minimum wage, which is to be phased-in until 2006, strongly suggests the need to consider additional reform measures in the pension sector.

In this area, the Portuguese authorities have recently adopted measures to align gradually the relatively generous pension system for workers in the general government sector, with the pension regime for private sector workers.

## **The importance of structural reforms to strengthen the growth potential of the economy**

The current potential growth rate of the Portuguese economy is estimated at around 2¾% to 3%, which is about ½% above the EU average.

Portugal's growth has historically relied on increased factor inputs (both capital and labour), with relatively small contributions from total factor productivity (technical progress). Therefore, one of the major challenges faced by the Portuguese authorities is to enact reforms that will contribute to a sustained rise in productivity growth.

In fact, Portugal's economic success in recent years has depended to a large extent on the high labour force participation, together with strong investment in physical capital.

With labour force participation already high and possibly decreasing returns to physical capital, future growth is likely to require stronger productivity growth. To that end it is necessary to tackle a number of structural problems associated with the low efficiency of the education system, insufficient spending on R&D (research and development), and weak ICT (information and communication technologies) diffusion.

As regards the education sector, Portugal has increased spending in this area substantially in recent years and education performance has strengthened somewhat. However, Portugal continues to score poorly in comparison to most developed countries. For instance, in Portugal the share of early school-leavers without upper-secondary education and not in training is by far the highest in the EU.

As regards competition in product markets, the establishment at the beginning of 2003 of an independent competition authority with powers similar to those in other EU countries, together with the approval of a new competition law in line with the more advanced legislation at the EU level is in my view a welcomed development which could potentially strengthen competition, thereby underpinning stronger productivity growth.

Another initiative which is very promising in my eyes is the recent creation of the Portuguese agency for direct foreign investment (API), entrusted with the active promotion of Portugal as a destination for foreign direct investment. This agency, together with the compilation of a new code for foreign investment could play a decisive role in facilitating FDI inflows, particularly as it gradually becomes, as envisaged, a one-stop shop for foreign investors.

### **Some final remarks**

Let me now come to some conclusions:

Firstly, there is a clear lesson for all Member States of the European Union to be learnt from the example of Portugal. As much as economic and monetary integration creates new economic opportunities, it requires a higher degree of flexibility and responsiveness to market forces in order to secure international competitiveness.

Furthermore, economic policies remaining under the competence of national authorities, notably fiscal policy, have to display an accrued degree of responsiveness both to cyclical fluctuations and to the economic shocks that affect in an asymmetric way countries of a monetary union.

Secondly, there is a clear need in Portugal to curb the fast rise in current expenditure of recent years. This requires the implementation of better expenditure control mechanisms to prevent the recurrent overshooting of budgetary targets. In this regard, the Portuguese parliament adopted in 2002 a Budgetary Framework Law in order to address the lack of co-ordination, and to shorten the lags involved with the identification of budgetary slippages, and the adoption of the necessary corrective measures. In this respect, I congratulate the Portuguese authorities on the progress achieved in such a short time in improving the collection,

processing and transparency of general government accounts, as recommended in the excessive deficit procedure for Portugal of last year.

Thirdly, expenditure has to be redirected towards those areas which give the highest impact on economic growth. The Portuguese government will, therefore, have to clearly identify its priorities. In this context, given the catching-up needs of the Portuguese economy, cuts in government investment plans should be kept to a minimum and limited to those projects with the lower rates of return; while reforms should be vigorously pursued to increase the efficiency of resource use in education. In this regard, I note with satisfaction that the Portuguese government has made in the 2002 update of the stability programme the commitment of maintaining a high level of government capital expenditure throughout the 2003-2006 period, following the cuts registered in 2002.

Fourthly, the reinforcement of budgetary co-ordination within all government sectors, the shortening of information lags, and the improvement of the accuracy of government accounts will not be sufficient to complete the process of budgetary consolidation if not accompanied by a comprehensive programme of structural reforms with the twin objectives of: first, to curb primary expenditure growth, and address the problems posed by ageing populations; and second, to improve the allocation of resources by enhancing incentive mechanisms and the functioning of markets.

Last but not the least: let me call your attention to the fact that a large consensus seems to be emerging in the Portuguese society as regards the urgency of implementing an ambitious and wide ranging programme of structural reforms. In fact, in early January of the current year, the Portuguese parliament approved by a large majority, including the support of the main opposition party, a declaration in favour of the updated stability programme, which as you know enumerates a comprehensive list of reforms. Both the Council and the Commission have considered that these measures are broadly consistent with the 2002 Broad Economic Policy Guidelines (BEPGs).

Let me stress that in my view, the building up of a large political and social consensus on the necessary reforms could not only facilitate their early adoption, but also be conducive to greater confidence in the economy -a commodity that is in such short supply at present- enabling a faster recovery of economic growth.

Thank you for your attention