



# The economy of Portugal and the European Union: From high growth prospects to the debt crisis

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## ABSTRACT

This paper documents some of the recent economic history of Portugal, since its accession to the EEC, to the adoption of the Euro and more recently to the financial and economic crisis. In the first part of the paper we show the economic performance of Portugal during the last 25 years till now, from the fast growth of the late 1980s and early 1990s to the current recession. We point out some of the reasons for this trajectory – slow productivity growth, disconnection between productivity and wages, continued external and public deficits – and choose three areas that must be improved in order to reverse the current downward spiral – justice needs to be more effective and faster, education needs to improve its quality and distribution across the population, and the public administration must become more efficient.

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## 1. Introduction

When peripheral countries join rich countries to form a customs union, which also becomes a monetary union, they may be tempted to make use of perceived opportunities. Using some of the latter might be called “responsible”, while others might be called “irresponsible”. In the case of the European Union the “responsible” use of opportunities was the transfer of resources to the peripheral countries for the purpose of building up the country’s infrastructure (Baer & Leite, 2003). Also “responsible” would be the use of these resources to improve the productivity of various sectors of the economy.

The “irresponsible” use of opportunities consisted of the government of the peripheral country to borrow from the rich country in order to finance a rapid rise in social benefits, which were not related to productivity. In the case of the European Union, funds were abundant and cheap as creditors from Europe’s rich countries (mainly banks) had the perception that there was little risk in lending to countries that were in the same currency area and with no restrictions on capital flows.

The expectation, of course, was that the peripheral country would be able to service its growing debt because its GDP would also increase and therefore the country would be able to generate more resources to at least pay the interest on the debt stock. And to fulfill this expectation, the peripheral country would have to produce trade surpluses (perhaps combined with an inflow of direct foreign investments). Finally, to be able to produce trade surpluses, the expectation was that productivity in a number of sectors would rise to such an extent that the peripheral country would become competitive abroad.

As we shall show in this article on Portugal, one of the peripheral economies of the European Union, this good scenario did not occur.

## 2. Expected performance of Portugal within the Euro

The last fifteen years of the 20th century brought about institutional developments which seemed to promise a bright economic future for Portugal. The country entered the European Union in 1986, joined the Exchange Rate Mechanism (ERM) of the European Monetary System in 1992, entered the European Monetary Union (EMU) in January 1999, and began circulating the Euro on January 1, 2002. In addition, the EU committed itself to transfer resources to its “peripheral economies” to build up their infrastructure, which

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**Table 1**  
GDP and unemployment.

	1996	1999	2002	2005	2008	2009	2010	2011 <sup>f</sup>	2012 <sup>f</sup>	2013 <sup>f</sup>
GDP real growth rate	3.7	4.1	0.8	0.8	0	-2.9	1.4	-1.9	-3	1.1
Final consumption of households	63.4	61.9	61	62.8	64.8	63	63.9	Na	Na	Na
Final consumption of general government	17.7	18.1	19.7	21.1	20.1	22.1	21.6	20.6	18.7	17.4
Gross fixed capital formation	23.6	27.3	25.6	23	22.5	20.6	19.8	18	16.9	17.1
Exports	27.2	27.1	27.6	27.7	32.4	28	31	35.3	38.1	40
Imports	34.4	37.4	35.9	37.1	42.5	35.4	38.2	39.5	38.6	38.7
External balance of goods and services	-7.2	-10.3	-8.3	-9.4	-10.1	-7.4	-7.2	-4.2	-0.5	1.3
Unemployment rate	7.2	4.4	5	7.6	7.6	9.4	10.8	Na	Na	Na

Source: Eurostat.

With the exception of GDP real growth rate and unemployment rate all indicators are measured as % of GDP. Superscript f refers to forecasts.

would facilitate their integration with the more advanced European economies. All members of the EMU were committed to observe strict fiscal discipline, keeping budgetary deficits to a maximum of 3% of GDP.

Given fiscal and monetary stability, with open borders, no exchange rate risk, and a labor force whose earnings were substantially below the EU average, it was expected that many European and non-European multinationals would make substantial investments in Portugal. All these factors would contribute to high rates of growth, which in the long-run would allow the country to attain the quality of life of Europe's more advanced economies.

### 3. Disappointments

All these great expectations for the Portuguese economy were not fulfilled. This claim can be corroborated using many statistics. We start by showing in Table 1 the average yearly growth rate of GDP as well as some of its components between 1996 and 2013, for some selected years, where the last three years of the series are forecasts provided by Eurostat. The economic growth of the Portuguese economy greatly decreased in the early 2000s. The average yearly growth rate of GDP in the second half of the 1990s was 4.22%, while the yearly growth rate in the first decade of the 21st century was only 0.61%. Gross capital formation as a percent of GDP declined from a yearly average of 27.2% in the second half of the 1990s to 23.7%; and public investment also declined (see Table 1). In this table, one also notes a large difference in the export/GDP and import/GDP ratios, the latter being always larger than the former.

It is interesting to note that the expected higher levels of investment due to lower interest rates and lower inflation rate did materialize, but only for a very short period of time. In 1999, when Portugal joined the EMU, gross capital formation increased to 27.3%. However, in 2002, when the Euro started circulating, it had already gone down to 25.6%, reaching 23% in 2005, which is below the level reached nine years before, when interest rates were much higher.

The unemployment rate reached its lowest level in 1999 after several years of steady decrease, but it increased substantially in the subsequent 10 years (more than doubled). This fact is obviously correlated with the reduction of gross capital formation in the country.

Another source of disappointment is the external sector of the Portuguese economy. As can be seen in Table 2, Portugal's economy suffered from high current account deficits during the entire period. Moreover, even though real GDP growth declined, the current account deficits remained high. Some explanations for this event are discussed in the next section.

Also worth noting is that despite the expected large investments by the richer countries of Europe as consequence of Portugal having joined the Euro, direct investment was very low.

The disappointing performance of the Portuguese economy can also be noted in its fiscal accounts. Table 3 shows that Portugal never complied with the EU's rules regarding fiscal deficits, in particular, running a fiscal deficit below 3% of GDP.

The fiscal failure was largely reflected in the rapid growth of Portugal's net external debt, which went from 22.5% of GDP in 1999 to 84.2% in 2010, as shown in Table 4. This is associated with the high current account deficits faced by Portugal's economy in the same period, which indicates that the investments, consumption

**Table 2**  
Balance of payments (% of GDP).

	Current account					Financial balance				Capital balance	Errors and omissions
	Total	Goods	Services	Earnings	Transfers	Total	Direct invest.	Portfolio invest.	Other invest.		
1996	-4.1	-8.1	1.2	-0.7	3.6	3.1	0.5	-1.3	4.6	1.9	-0.9
1997	-5.9	-9.2	1.2	-1.1	3.3	3.7	0.2	0.5	4	2.4	-0.2
1998	-7.1	-10.8	1.5	-1.2	3.3	4.2	-0.8	-0.5	5.9	2	0.9
1999	-8.7	-12	1.5	-1.3	3	7	-1.6	2.9	5.9	2	-0.3
2000	-10.4	-12.9	1.7	-2	2.9	9.3	-1.3	-0.9	11.5	1.3	-0.2
2001	-10.3	-12.4	2.2	-2.9	2.8	9.1	0	3.4	6.2	0.9	0.3
2002	-8.3	-10.5	2.4	-2.3	2.1	6.7	1.5	2.9	3.2	1.4	0.1
2003	-6.5	-9.4	2.5	-1.6	2	4.4	0.4	-3.6	3.6	1.8	0.2
2004	-8.4	-11	2.7	-2	1.9	6.8	-3	0.5	8.3	1.5	0.1
2005	-10.4	-11.9	2.5	-2.5	1.5	9.1	1	-0.2	7.5	1.1	0.1
2006	-10.7	-11.5	3.1	-3.9	1.6	9.5	1.9	2.4	4.2	0.8	0.4
2007	-10.1	-11.3	3.9	-4.1	1.5	8.5	-1	5.9	3.1	1.2	0.3
2008	-12.6	-13.4	3.8	-4.5	1.4	11.1	0.8	8.5	1.7	1.5	0
2009	-10.9	-10.6	3.5	-5.2	1.3	10.3	0.8	8.9	0.5	0.8	-0.3
2010	-9.9	-10.4	3.9	-4.6	1.3	9.1	4.4	-5.6	10.7	1.1	-0.3

Source: Pordata.

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