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GLOBAL COSMOPOLITAN ECONOMICS, THE EURO AND THE PORTUGUESE ECONOMY

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Abstract

Despite favourable external circumstances, in the last decade the Portuguese economy developed a model of *imbalance* and *dependence* based on the disparity between production and consumption, which was financed from the outside and led to anaemic growth, severe deficits and explosive debt, much similar to the Latin American populist models of the past. The restrictions related to the adoption of the euro and inadequate economic policies are the determinants of this process, and, simultaneously, the barriers that need to be overcome. The internal devaluation/recessionary policy, wrongly presented as a close replacement for external devaluation/expansionary policy, underestimates the recessive effects on demand and the way it gets aggravated amidst strong indebtedness, fostering a deflationary spiral that tends to undermine the policy of austerity that is essential to reduce the imbalances.
Doubts about the benefits of the abatement of all obstacles (including those of a monetary nature) to free trade among countries of very unequal development, long expressed by Friedrich List, are intensifying. In the absence of own currency, sovereignty and discretionary budgetary policy will be reduced in favour of prescribed rules, limiting economic policies to microeconomic and mesoeconomic frameworks. Due to the lack of an independent exchange rate mechanism, the exports sector sets the pace for the growth of the economy and of wages in the long term, while the impossibility to devaluate tends to lead to cumulative imbalances that are only offset by the occurrence of crises. Avoiding the latter requires paced wage and social policies, and increasing the rate of growth of the product and wages requires the development of an exports sector with high added value. This is the policy and strategy narrow path that Portuguese economy needs to tread.

Keywords

Cosmopolitan economics; euro; Portuguese economy; crisis; imbalance; wage deflation; devaluation; macroeconomic policy; microeconomic policy; demand; debt sustainability; growth

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1. Introduction

Today the economies in the periphery of Europe face a particularly difficult situation that threatens the entire continent and has strong implications for the global economy. Greece's economy has entered into effective bankruptcy, while the Portuguese one seems to be following an equally dramatic similar path. Understanding the nature of the imbalances that shape the Portuguese situation and the conditions for overcoming them requires an examination of the framework and dynamics where the Portuguese economy fits in. The present text also aims to reflect on current practices to overcome the crisis and discuss the conditions for recovery towards economic growth and real convergence.

I shall start by examining and systematizing the form Portugal's economy became part of international dynamics, particularly in the euro zone, establishing three periods: European integration and economic and social progress, the euro and stagnation, and recession and debt.

In section three I analyse the nature of the model that has been systematized in the Portuguese economy, based on the major imbalance between production and consumption that mimics the stagnation and dependence model, which inevitably tends to be explosive and has occurred in previous decades in other contexts and regions.

I shall proceed with an analysis of the economic policy that has been conducted, mainly with regards to wage deflation, which I believe to be the core point. In addition to the psychological aspects, I will explain the basic difference between external expansionary devaluation and recession-inducing internal devaluation, underlining the common underestimation of the consequences of lower wages on domestic demand, particularly in situations of high debt, to comment on the limited and doubtful success of such policies.

Finally, before concluding, I shall review the dominant theories on foreign trade that advocate the benefits of free trade in all circumstances, and the analysis of Friedrich List in his National System of Political Economy (1841), who doubts these benefits when there are substantial differences in development and productivity, which is particularly significant in systems with a single currency.

I shall examine the consequences of the inexistence of own currency and monetary policies for budgetary policy, which tend to follow rules, which leaves little room for discretionary policies. I will attempt to demonstrate that, in the absence of an autonomous exchange rate mechanism, the rhythm of export growth sets the pace for economic growth in the long term, while the impossibility to devaluate tends to lead to

unbalancing cumulative processes that get absorbed only by crises. Preventing the latter from occurring requires wage and social policies marked by rising exports and a state restricted as to its structure, but not necessarily as to its functions.

2. The inclusion of the Portuguese economy in the international system

The first reality that the Portuguese economy had to face was an international context characterized by the *acceleration of globalization* and its insertion in the *euro zone*. In turn, the acceleration of globalization encompassed several aspects, of which two are essential: the development of a *new geoeconomics* and an *increase in inequality in the domestic distribution of income*, both statistically observable.

The new geoeconomics is characterized by channelling growth to other parts of the world, supported mainly on the economic growth of emerging countries (Farto and Morais 2008), from which our economy is detached and with which it maintains limited relations. This situation prevents us from benefiting from this growth dynamics, but does not avert the intensification of global competition, especially with regard to our traditional markets and to comparable technological activities and specialization levels.

A second characteristic of this globalization process has to do with the development of a marked international pressure to maintain very uneven distribution systems in fast growing emerging countries, and to keep the increase of domestic inequality within developed countries where capitalism has long showed a "human face", thus increasing competition pressures and limiting the rise in demand[1] (Farto and Morais 2008, and OECD, 2010).

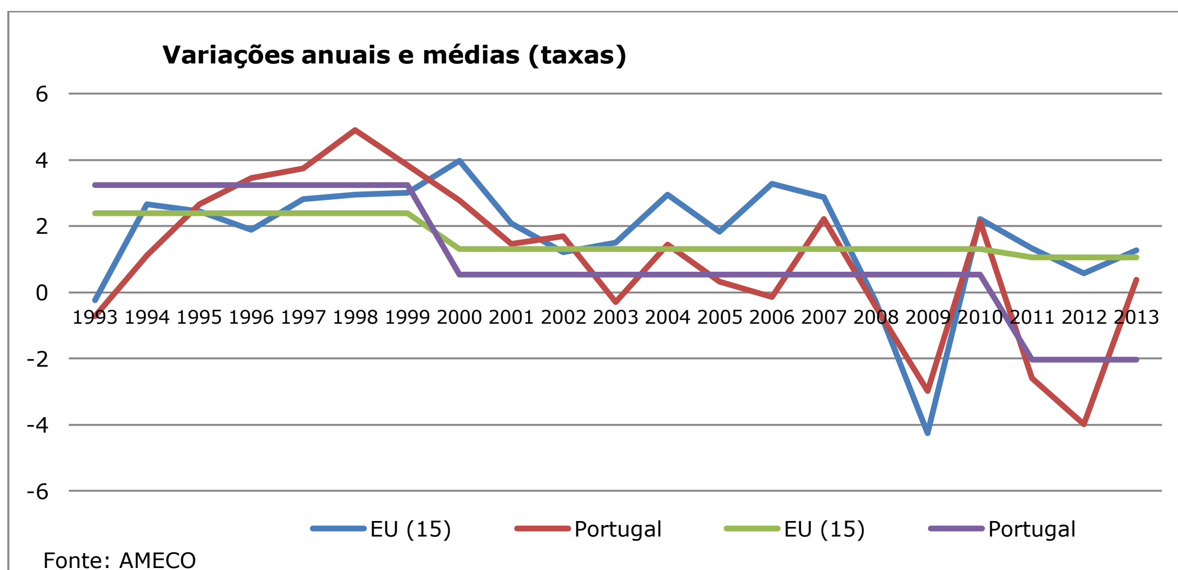
The second major axis of our external inclusion, which has decisively conditioned the current development process, is related to the insertion of Portugal in the euro zone, particularly to the conditioning factors or the most important choices, that is, the *effects of enlargement*, *joining the euro* and the *monetary policy* adopted.

In the process of European integration there were *three periods of Portuguese economy*: the first was our integration into the European Union (EU), supported by favourable international demand, market expansion, international investment, and structural funds, which corresponded to a period of strong growth in economic activity. This was the period of **convergence** that extended to the end of the 1990s (3rd quarter of 1999). The second phase was one of **divergence** and corresponded to joining the single currency. It is associated with economic stagnation, increase of all the imbalances in the Portuguese economy, and rampant debt. The third phase, where we stand today, is a period of dramatic **recession**.

The evolution of the growth rates of the growth domestic product (GDP) shown in the chart below, particularly the average rates, clearly illustrates the three stages mentioned above.

[1] This might provide an important reason for the explosion of debt, in particular the U.S. economy, in order to maintain living standards that the new income distribution undermines.

Chart 1



2.1. European integration and economic and social progress

The revival of economic activity in 1985 took place in a context that resembles a small miracle, creating illusions about the future. The "external shock" manifested itself in the combined effect of several events, namely the falling dollar, the drop in international interest rates, and the sharp fall in the prices of oil and raw materials, while internally a good agricultural year and plenty of rainfall contributed to the reduction of imports, particularly in the energy sector. As a result, the current account (CA) had a positive balance that led the government at the time to dispense the use of 185.7 SDR (Special Drawing Rights), which represented 40% of the amount previously agreed with the IMF (Farto and Mendonça, 2006).

While integration into the EU created favourable expectations in Portuguese entrepreneurs, particularly in relation to new ease of access to European markets, some international companies felt increasingly confident with regard to their possible transactions in Portuguese territory, taking advantage of the existence of a cheaper workforce with the same skills and training. This decisively contributed to one of the best development period of Portugal's economy and surely the best for democracy in Portugal.

Portugal was able to benefit from a strong external thrust brought about by the integration process while maintaining a crucial protective barrier; its own currency

2.2. The Euro and stagnation

From 2002, the period of **stagnation** and of **real divergence** of the Portuguese economy is clearly perceptible. Despite the possibility of accessing large markets and vast and varied forms of financing, and the fact that it benefitted, at least initially, from

relatively low labour costs, an advantage that worn out over time, Portugal's economy took insufficient advantage from these factors, keeping a low competitive edge. The fragility and vulnerability of the production system, based on a limited specialization and on somehow limited activities with low reduced added-value, led to reduced competitiveness and limited export capacity due to the atrophy of marketable goods and services[2].

The deterioration of the shares of Portuguese exports on a global and European scale (albeit less severe) and a slight improvement of services worldwide (but not in Europe) denotes a slow but steady loss of competitiveness. The analysis of the real exchange rate (calculated on the unit costs of production) of tradable activities reveals a progress pattern among economies of the north of Europe, and competitive difficulties on the part of the economies of the south, namely Portugal, recording a loss of competitiveness in the last decade of about 15% (Mateus, 2010).

The external opening exerted a persistent pressure on the sectors exposed to international competition, which created a significant asymmetry in the increase of prices unfavourable to the tradable sector (Farto and Mendonça, 2006). The divergence between the increase in production costs for the entire economy and the price increase of exports during the decade reached 7%, which means the reference for the setting of prices and yields was much more stringent for tradable activities. Higher inflation on goods and services more sheltered from foreign competition enabled draining top quality resources from these activities, reducing the potential for development and success in the tradable sector.

It is true that there were unfavourable external factors, including the enlargement to the east and the monetary policy of the European Central Bank (ECB). The EU enlargement to the east increased the competitive pressure on our economy, particularly in some industrial sectors, both in other countries and in ours, leading to drastic reductions in production or simple destruction, while the new countries became a more favourable alternative for international investment. The benefits that Portugal had enjoyed from joining the EU now moved to the east.

The monetary policy conducted by the ECB also contributed to worsening problems in the entire euro zone and to its stagnation during this period, also reflected in the Portuguese economy. I have argued that restrictive monetary policies are inappropriate for a non-optimal currency area like the one we have today. I particularly believe that a 2% inflation target is objectively deflationary (Farto, 2006 and 2009), as it does not allow, without nominal wage reductions, making the inter-sector and inter-regional adjustments that economic dynamics dictate.

As can be seen in the table below, in many countries the changes in GDP since the adoption of the euro up to 2008 are significantly lower than in the previous identical time period. In this comparison, Ireland and Portugal were the great losers, and Greece and Finland the big winners. However, if we take a longer period, by 2012, compared with the previous period, there are only losers, Portugal and Ireland faring the worst, although a wide range of countries also suffered major losses. The crisis and the

[2] The poor productive and industrial tradition of the country has been dragging over time, hand in hand with a persistent aversion to business risk, a weak inclination to innovate, underestimation of export activities, and insufficient emphasis on education and culture.

hesitations of the monetary policy seem to be eliminating any gains that eventually could be attributed to the single currency.

Table 1

Country	89/98	99/08	Deviation	85/98	99/12	Deviation
Austria	24,84	22,82	-2,02	36,07	25,80	-10,27
Belgium	21,99	19,69	-2,30	37,82	21,18	-16,63
Finland	12,58	32,29	19,70	32,19	30,10	-2,09
France	16,07	17,59	1,52	32,77	18,63	-14,14
Germany	21,42	15,02	-6,40	36,02	17,24	-18,78
Greece	16,66	37,08	20,42	24,07	13,52	-10,55
Ireland	72,10	49,45	-22,66	94,85	40,10	-54,75
Italy	13,68	11,81	-1,87	29,98	5,98	-24,01
Luxembourg	46,42	45,88	-0,54	99,35	42,95	-56,40
Holland	30,77	21,40	-9,36	47,69	20,00	-27,70
Portugal	34,86	12,45	-22,42	68,49	5,52	-62,97
Spain	25,48	34,02	8,54	51,67	27,46	-24,21

Returning to Portugal, what is truly astonishing is that neither the over consumer practices of the Portuguese supported by cheap credit, nor the markedly expansionist economic and social policy were enough to boost an economy undergoing stagnation.

However, whereas these policies did not help to overcome the stagnation tendency, they proved decisive in developing the imbalances that meanwhile had grown deeper, leading to the present crisis. The economic policy was wrong in the way it conducted the budgetary policy[3], in the disaster that the public-private partnerships turned out to be[4], and in the infectivity of some reforms[5]. In addition, it did fail by not implementing indispensable structural reforms, namely at the level of job creation and justice.

In fact, a set of populist measures conducted in untimely fashion contributed to enhancing the structural imbalances of the economy, leading to the disarray of internal and external debts. "*Portugal was the first country to breach the Stability Pact as early as 2001. Since then, it has breached it every year, if we do not include the extraordinary measures, except in 2007 and 2008"* (Neves, 2011: 217).

[3] The expansionary budgetary policies remained unchanged even during times of economic expansion, when what was paramount was to consolidate public accounts; housing loans at cheap interest rates continued to be granted, while lower interest rates made money cheaper; the new wage system for the civil service was introduced, which increased labour costs, not taking into account external competitiveness.

[4] Public interest was not always safeguarded, while the deterioration of the legal system contributed to swelling the chaos of our collective life, generating huge concerns about the future of our democratic system.

[5] The reforms in public administration through the creation of a significant number of institutes, either new ones or by means of reforming existing Directorates General, and extending social functions without taking into account the situation of the national economy led to an increase in the "fatty layers" of the state. The attempts undertaken in relation to taxation and justice produced the same results: increased structural imbalances and costs in the context of the Portuguese economy.

In brief, it can be said that among the multiple factors that always influence an economy, the euro and inadequate economic policy were the father and mother of all problems we are facing today. The adoption of a stateless currency by a group of countries that have renounced their own currency has led to an insufficiently tested new reality, with consequences not yet fully observed and analyzed, particularly in terms of conducting the actual economic policy.

2.3. Recession and debt

The model in which the growth of the economy over the last decades was based has led to stagnation of economic growth and to recession, worsening imbalances and, in particular, to the inability to finance the economy and the state in acceptable conditions.

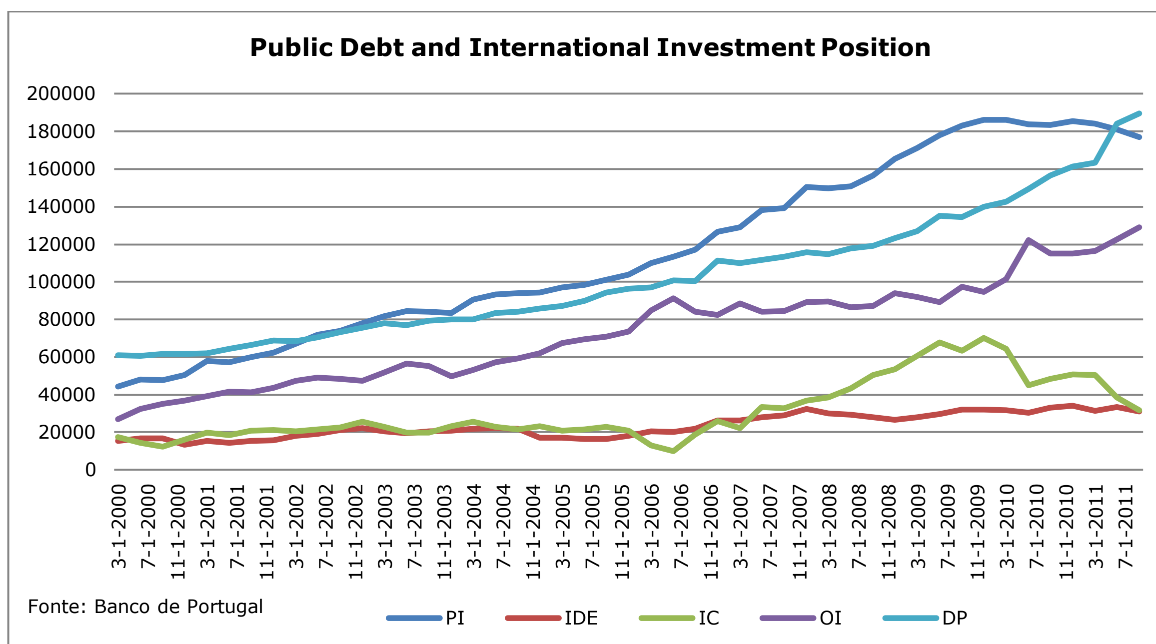
In fact, while the economy's tendencies towards stagnation were felt, the new monetary conditions[6] offering better (and cheaper) credit and access to easy money obtained through EU funds[7] stressed and encouraged imitation attitudes and behaviours, excessively consumerist, increasing household spending and debt. This preference for the present, translated in the reduced savings and increasing exuberant spending that characterized the general behaviour of economic agents in Portugal, particularly public agents, without corresponding growth in productive capacity, led to the constant imbalance in public and foreign debt, particularly the latter.

In terms of its GDP, currently Portugal is clearly a major debtor on an international scale, regardless of the criteria used. The figure shows the evolution of the Portuguese public debt (PD) in millions of Euros, which has tripled since 2000, surpassing the GDP, and the position of international investment, which also indicates the unsustainable growth of external debt, particularly visible in the evolution of the variable *Other Investment* (OI). The investment position (IP) also reflects the stagnation of direct investment (DI) and the cyclical downturn of the portfolio investment (PI).

[6] Joining the euro has sometimes been questioned for different reasons. It is now clear and undeniable that some of its negative consequences, particularly the effect it had on the external competitiveness of the economy, have not been sufficiently taken into account.

[7] The relatively easy access to EU funds contributed to the development of corruption, political patronage and subsidy dependence, and influenced consumerist attitudes that contributed to the reduction of savings and to the sustained increase of new needs, which were met through increasing imports.

Chart 2



The recent tendency for the aggravation of public debt, implicit in the chart, is also worrying. In terms of public debt, in 2011 Portugal ranked 7th in a sample of 38 countries, being part of a rich and powerful group of countries, closely following Ireland, Greece and Spain, in addition to the U.S. and the UK, which experienced worsening of the debt ratio even more seriously than Portugal between 2009 and 2011 (Farto, 2011a).

Thus, the high level of debt and its recent dramatic aggravation, both at government level and externally, have become a time bomb whose explosion time is unknown but fatal, which strikingly limits any strategy for economic policy, forcing a current recessive orientation and the release of resources to maintain a high debt service in the future.

3. An explosive model of stagnation and imbalance

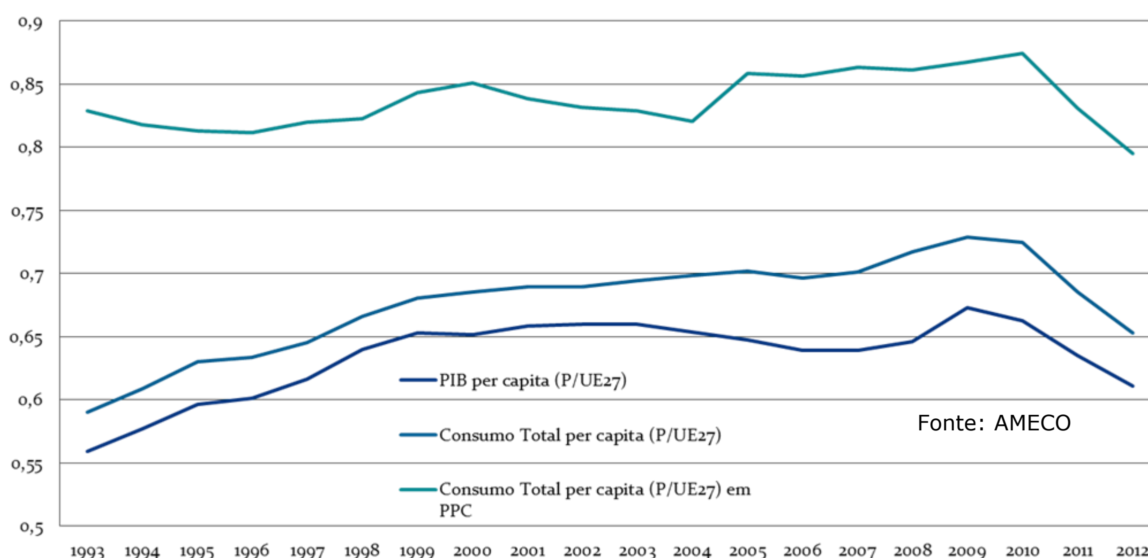
The systemization of the course of the Portuguese economy in recent decades has revealed two clear trends since joining the euro: anaemic growth, almost stagnation, and the development of important and persistent imbalances in public and external accounts. It is now important to specify the nature of the main relations that have been developed along this route.

3.1 The development of the basic imbalance between production and consumption

If we compare the ability to create wealth measured by the GDP with the level of Portuguese consumption, we note that in terms of wealth generation, Portugal

represents 64.6% of the EU 27 average, while consumption stands at 67.3%. This difference, which perhaps reflects our individual and collective preferences, is an indicator that clearly expresses the huge accrued imbalances and points to the size of the correction needed.

Chart 3



As mentioned above, the loss of currency and of monetary policy dramatically widened the imbalance of the model that was followed, making it untenable. By increasing the pressure on demand, with the falling interest rates joining the constant inflow of structural funds and permanent budget deficits, the adoption of the Euro and the consequent loss of foreign exchange policy increased pressure on imports and over-dimensioned the non-tradable goods sector. Under these conditions, our companies have proved unable to compensate the ever-growing demand for imported goods by increasing national production. The demand for exports was driven by imitative behaviour and policies that fuelled unprecedented *consumer exuberance*, thus generating a growing unrelenting external imbalance.

An analysis leading to similar results can be done by comparing the evolution of wages and that of productivity, like the one made by João César das Neves, who summarized it as follows: "*…our external difficulties and debt are not the result of producing little. Instead, we earn too much for what we produce*." (Neves, 20011: 165).

3.2 A model of stagnation, imbalance and dependence

As we have seen, the Portuguese economy had one of the weakest GDP growths in the last decade, just ahead of Italy and Haiti. This stagnation of the product has contributed to maintaining the fundamental imbalance between production and consumption financed by the progressive increase in foreign debt. The model in itself does not bring any novelty. It does not differ substantially from the dependence model

developed by many economies in the past, namely those of the then called developing countries, like Brazil and Argentina, among others, and by the Portuguese economy before joining the EU.

Despite simplifying, we can consider two subgroups with very different economic characteristics in the euro area. Countries in the centre, represented by Germany, have a high productivity economy, modern technology and a current account surplus. A second group of countries, where Portugal is included, have low productivity elementary technology and high constant external deficits in their current accounts. Behaviour in the first group of countries tends towards household saving and strong export propensity, based on a rich industrial sector and on exports directed in particular to the peripheral countries in southern Europe. Conversely, southern countries have difficulty in selling goods and services that may be of interest to markets in the north, despite their size and importance, in order to make up for the situation described above.

Thus, given the asymmetry described above, economic relations between these two groups of countries would not seem very promising. However, the banking systems of the regions solved the problem, with those in the centre collecting the saving of local families and lending them to banks in the south, which in turn lend them to families, investors and peripheral states. Of course there is an assumption of credibility on the part of southern countries, which promise to pay back the capital at a periodic interest rate.

This mechanism, whereby the **exchange of current goods and funding is conducted against promises of future payment**, contrary to what may seem, has enormous potential. This is because both parties (and the parties' interests), benefit from it[8]. Countries in the centre benefitted because this mechanism contributed towards high growth and low unemployment in the region, while families accumulated financial assets, whereas peripheral countries benefitted too, with significant population groups enjoying lifestyles that otherwise they would not be able to afford (at least in this period).

This mechanism, which enabled keeping a very asymmetric exchange system, tends to engender a type of economic relations that lead to very serious imbalances, as now found, and which very few people sensed. It led to the atrophy of national productive structures, clearly confirming the fears that led List (List, 2006) to advocate *learning protectionism*. The premature total confrontation between very different production structures could not but result in constant weakening of a lower quality and less developed productive structure, widening the competitiveness lag of southern European countries with regard to countries in the north[9].

The single currency acted as an amplifier of the imbalances, as countries from the south borrowed repeatedly under the same conditions as countries from the north, and the perception of risk between the two regions was long perceived as being the same,

[8] This was clearly a joint responsibility. Both regions benefitted from the situation. Countries from the centre, eager to do business and to have profit, lent out easily, underestimating risks. Peripheral countries, in turn, wanted to have the same goods as those in the north; accordingly, they got into major debt, underestimating the challenges of the future.

[9] In the last decade, Germany's wage growth was lower than productivity, in contrast to what happened in southern European countries, for which reason the competitiveness gap between the two regions widened significantly.

prompting low interest rates in both areas. The relatively low ECB interest rate of the whole euro zone led to a lending boom on the part of southern countries, which got strongly in dept (specially on the state's part, like in Greece, or specially by private individuals, such was the case of Spain or Ireland, or more or less distributed, as in Portugal), while northern countries accumulated financial assets.

To a large extent, this kind of relationship existed prior to joining the European community. However, integration developed and deepened the pre-existing model, without bringing about any significant change, I argue that, in essence, this is a situation that could be termed of **dependence**, due to the strong analogy with the dominant model that prevailed in many developing countries in previous decade[10].

3.3. The limits: an explosive model

The type of model to which I refer can be represented by the equation: Ek-Sk = (S-I) +(T-G) +(X-Z)[11] with (Ek-Sk) > 0, (S-I) <0, (T-G) <0 and (X-Z) <0, which expresses the external funding of the savings deficit, the state deficit, and the current account deficit, and the conditions that put debt on a downwards explosive route, often leading to serious financial crises with unpredictable political outcomes, can be deduced analytically.

Is there a limit to the functioning of this system? No doubt there is, but it is impossible to predict the time of the explosion[12]. Basically, internal debt becomes explosive when the real interest rate is greater than the rate of economic growth and foreign debt and when there is a) systematic current account deficits, b) positive flows of loans and funding and c) the rate of external interest rate increases.

It is easy to see that all these conditions were present in Brazil at the end of the 1990s, as they are today in countries like Greece or Portugal. Brazilian minister Delfim Neto defended that *"Debts were not made to be paid, but to be rolled over".* This is partly true, but it becomes a serious problem when the financial market refuses to make the "*rollover*" of debt on terms that are acceptable to the country.

These difficulties manifest themselves in a number of well-known situations, particularly in the number of unsold securities at internal and external auctions, and in the increase in interest rates to unsustainable levels, which ultimately impose the

[10] The temptation to compare our growth model with what is sometimes known as the *Latin American populist model* is huge. The model is based on *overvalued currency*, often associated with fixed parity against a strong currency, and important budget deficits that enable increasing employment, real wages and the welfare of workers above labour productivity, without proper economic structural advances. This model, which is not sustainable, always ends up generating imbalances that inevitable lead to exhaustion and even collapse.

[11] In this equation, Ek and Sk represent financial flows in and out; S and I account for private saving and investment; T and G stand for public revenue and expenditure; X and Z represent exports and imports.

[12] It starts to be in trouble when investors successively begin to fear that the debt is becoming untenable, as happened recently with Greece. When this opinion becomes significant, it leads to crisis, and when it becomes dominant, the system collapses.

restructuring of internal debt, mandatory applications and forfeitures, stock market plunges, privatization, currency devaluation, and recession: in a word, crisis[13].

Will the explosion of the debt in this model in a currency area like the euro be inevitable? Not necessarily. If a monetary zone politically behaves as a country (whether it is a federation in institutional terms, or not), assuming **unlimited solidarity** from all its members, then restrictions on the conduct of economic policy and even on growth will not be fundamental, although not necessarily providing a real convergence. The dismantling of all obstacles, namely of a monetary nature, to free trade will mean that any economic imbalance occurring in less competitive economies will be compensated by the community as a whole, which should maintain, in a more or less constant way, a flow of unilateral transfer to *less developed economies, financing the fiscal and external imbalances that tend to be generated*.

However, if this is not the case[14], that is, if the more developed countries fear that important and persistent deficits in all countries will eventually create a monetary stability problem or that those deficits may only create monetary instability and political difficulties in some countries, it is likely that the currency area ends up taking a **limited solidarity** that will tend to exclude the non-acceptance of budget deficits and/or the debt pooling. This is what is now happening in the euro zone with all its consequences.

4. The Portuguese economic crisis and economic policy

We have seen that the growth model that became consolidated in the Portuguese economy and even the characteristics of the current crisis are not essentially different from other well-know situations described in international economic history literature, particularly with regards to Portugal in the past. However, there are fundamental differences in context that make all the difference in the answers that can be given. I refer in particular to the *levels of the debt* (both public and external) and to the *impossibility to have our own monetary policy*, as a result of integration in the euro area. These *two constraints* are paramount when dealing with the problem of defining an appropriate economic policy.

In the past, there was a pattern that could be taken as a reference, which was the programme of measures suggested by the International Monetary Fund (IMF), and whose implementation led to vast knowledge of its strengths and limitation. However, the aforesaid constraints undermine much of the standard programme, such as currency devaluation, which is its centrepiece[15], requiring thus a thorough reflection on

[13] In the European sovereign debt crisis, the government in Germany and in other creditor countries realized that banks could carry heavy losses that would jeopardize household savings in the north, for which reason it became necessary to save the banks to protect household savings and to avoid the risk of panic that the collapse of an European banking system already weakened by the sub-prime crisis would bring about. Thus, those governments agreed to grant new loans as long as harsh austerity programmes were put into practice in debtor countries: fiscal discipline, cuts in government spending, increased taxes, structural reforms, and wage deflation. Bailouts in Greece, Ireland and Portugal have provided the necessary liquidity to enable the economies to continue to work.

[14] Naturally, countries that need help are the least well positioned to claim unlimited solidarity**.**

[15] In this context, in a package of measures of austerity that included control of demand, higher interest rates to attract capital, and other emergency measures dictated by circumstances, currency devaluation was a means to contribute decisively to the recovery of lost competitiveness.

the economic policy being implemented in countries experiencing difficulty in managing sovereign debt.

Within this framework, today economic policy seems guided by three areas: *budget consolidation* to drastically reduce the needs of public funding and to create conditions for public debt sustainability; *wage deflation*, with the double purpose of reducing public debt (like wages in the civil service) and improve the external competitiveness of the economy by reducing costs; and the implementation of a set of *liberalizing structural reforms* (including privatization and flexible labour market) in order to introduce efficiency and foster economic growth.

Clearly, structural reforms will not have significant consequences on the economy in the near future, even if the Portuguese government places high hopes on them, due to their own characteristics and times. Accordingly, it is difficult to anticipate the extent of their actual effect.

It should be stressed that budgetary consolidation is attained at a pace and within the framework of measures to be adopted that depends largely on the pressure of creditors, especially the international authorities that act on their behalf or constitute them (IMF, ECB, EU). This policy includes the usual measures of tax increases and reduction of certain expenses and taxes, like the Single Social Tax (SST), and, in addition, calls for deflation of wages and of pensions as never before. This is the instrument I will focus on next.

4.1. Wage deflation

Let us start this point with accuracy: although the effects may be similar, it is appropriate to distinguish what we can call **forced wage deflation**, when a country that does not have its own currency is forced to reduce the wages of civil servants and pensioners due to its inability to meet its obligations, from **voluntary wage deflation**, when the latter is presented as a policy, that is, as an instrument used to achieve certain economic objectives, such as to reduce unemployment and to increase competitiveness. It is mostly in this sense that I will address the topic.

Wage reduction, in addition to the socio-economic impact of reduced purchasing power, causes a major sense of injustice, undermining social cohesion. This effect, which is subliminal and difficult to measure, yet is often underestimated, is by no means negligible in the behaviour and attitudes of workers. In his *General Theory of Employment, Interest and Money* (1936), J. M. Keynes noted a fundamental difference between the effect of a decrease in real wages and of purchasing power caused by inflation, which has relatively neutral effects on relative wages and on the perception of justice[16], and the effect of reducing normal wages in respect of which "*…* there is, as a rule, no means of securing a simultaneous and equal reduction of money-wages in all industries… [and therefore]… it is in the interest of workers to resist to a reduction in their own particular case" (Keynes, 1973: 264).

[16] The sense of injustice naturally grows in the presence of additional factors, such as a large distributive imbalance and/or if the responsibility for the seriousness of the situation can be associated with certain sectors, such as the financial one, which has higher yields, or with politicians who, supposedly or actually, have financial perks.

Thus, it is understandable that economists have long considered this reduction to be nearly impossible to achieve. J. M. Keynes explicitly wrote that workers offer a firm resistance to reduced wages, arguing that it is almost impossible in a democratic environment. "It is only in a highly authoritarian society, where sudden, substantial, all-round changes could be decreed, that a flexible wage policy could function with success."[17] (Keynes, 1973: 269)

But even non-Keynesian authors, although considering this worker behaviour as being non-rational, admit this resistance as a fact. In addition to having led to a distribution of income in detriment of labour, globalization[18] has brought about a change in power relations that has facilitated a certain "*vulgarization*" of nominal wage reduction, eroding the modern and progressive wage relationship in favour of its condition as a basic commodity, presenting *labour as a commodity* as K. Marx in Volume I of *Capital* (1867).

Moreover, O. Blanchard (2006) himself, who recommended this therapy for the Portuguese economy, noted that the declines in nominal salaries pose psychological and legal problems that may lead to questioning the possibility of reducing social security taxes and labour costs this way, and maintain the volume of taxes withheld by, for example raising the value added tax (VAT), which the author believes it is difficult to do given the fact it is already high in the EU framework[19].

Besides these general considerations, three major impacts of wage reduction, equally present in the in-depth analysis carried out by Keynes in his *General Theory* (GT) deserve our attention today: the impact on external competitiveness, the consequence on demand, and the effect on debt.

4.2. The restoration of competitiveness: external devaluation vs. internal devaluation

The way to positively solving the problem of public and private over-indebtedness and external imbalance is to establish a path of economic growth. As governments and families have their expenses limited by high cost debts, this leads to recession, and, accordingly, restoring competitiveness amidst an atmosphere of austerity is, indeed, the only possible way to increase exports and income. We find a situation that is similar to past crises.

The effects of currency devaluation in fixed or semi-fixed exchange rate systems seem clear and are solidly implemented. By devaluating currency, exports become more competitive and imports become more expensive. This leads to greater demand for exported goods, a reduction in demand for imports, improving the balance of the current account. Thus, the policy is intended to encourage the expansion of the economy, in particular in terms of output and employment, and it may possibly lead to

[17] This is why he uses the wage unit in the GT as a yardstick of macroeconomic variables.

[18] With the entry of a skilled workforce with low wages and few rights from countries long subjected to dictatorships into the global labour market, the correlation of forces changed substantially in detriment of workers from more developed countries.

[19] The government may even increase the number of working hours without any increase in wage compensation. In this case, it reduces the unit labour cost without necessarily reducing nominal wages, although this may have some negative impact on employment.

some side effects, such as inflation, due to the import of products at higher costs in terms of domestic currency.

Naturally, the improvement of competitiveness through devaluation will always depend on the country's export profile, that is, on the type and quality of goods produced by countries and by their potential competitors[20].

Nevertheless, if we exclude the eventual trend of the export sector and/or the potential trend to the formation of over-profit in these sectors, there are no other negative side-effects resulting from devaluation, for which reason it is part of the set of standard economic measures fostered by international institutions like the IMF. Moreover, the increase in exports helps to mitigate the negative effects of the other set of austerity measures on demand, and they tend to generate positive psychological effects on the expectations of various economic agents.

If it becomes impossible, for a particular county part of a monetary union to resort to this instrument to restore competitiveness, economic policy will use the supposedly alternative tool of internal devaluation. Olivier Blanchard, among others, defends that "*the same result can be achieves however, **at least on paper**, through a decrease in the nominal wage and the price of non-tradables, while the price of tradables remains the same*."(Blanchard, 2006: 19).

Albeit less sure, Keynes did not rule out the potential effect of a wage decrease on foreign trade either. "If we are dealing with an unclosed system, and the reduction of money-wages is a **reduction relatively to money-wages abroad**… it will tend to increase the balance of trade"[21] (Keynes, 1973: 262).

Despite the reservations felt by Blanchard, he ends up stating that, with regard to Portugal *"a decrease in nominal wages sounds exotic, but it can substantially reduce the unemployment cost of the adjustment"* (Blanchard, 2006: 24). Given that wage moderation is insufficient within the moderate "inflationist" framework of the eurozone to reduce imbalances in a timely fashion, wage reduction, stronger in the public sector, would allow, alongside other measures, substantially reducing budget deficits and contributing to improve the competitiveness of the economy and the development of a path leading to balance in both ways.

However, we have reasons to consider that **wage deflation is not a replacement for external devaluation**, because the expansionary effects of the latter on domestic demand are at the antipodes of the deflationary effects on the same demand, and which result from lower wages. These effects, as admitted by Blanchard, are much more important than is generally admitted by the advocates of this policy.

4.3. Wage reduction and domestic demand

The process of internal devaluation in order to promote competitiveness normally starts with a reduction in public sector wages, which immediately causes a reduction of public

[20] A serious problem will arise if the export products are such that exports do not increase, even at lower prices. This is what may occur in the peripheral countries of the EU.

[21] "*The greater strength of the traditional belief in the efficacy of a reduction in money-wages as a means of increasing employment in Great Britain, as compared with the United States, is probably attributable to the latter being, comparatively ourselves, as a closed system*" (Keynes, 1936: 262).

expenditure and budgetary improvement. It then gets generalized to the entire economy, resulting in the reduction of production costs, namely tradable goods, which fosters production and import substitution, thus reducing external imbalance. Up to this point, the effects can prove similar to those that could be obtained through external devaluation, should that be possible.

The problem is that the story does not end here, leading to the development of important collateral effects. The consequence of reducing nominal wages on domestic demand, underlined by Keynes in chapter 19 of the General Theory, is indisputable, given that falling wages, particularly in middle income classes, has a very strong effect in domestic demand, heavily penalizing production and employment. This effect is additional to other measures of budget consolidation, such as tax increases, in reducing the disposable income of households[22].

The combination of all these effects can exert devastating consequences on demand, particularly on demand for national production, with consequent effects on employment[23]. This is a fundamental difference between domestic and external devaluation. While the latter has expansionary effects on employment and economic activity, domestic devaluation can lead to a long deflationary process, reducing prices, production, wages, and income. It must equally be noted that this deflationary spiral could more easily become a reality in those cases when the economy is over-indebted.

4.4. Domestic devaluation amidst widespread debt

The effects of deflation on debt and its consequences have long been stressed by several authors. On the increase of the real value of debt, Keynes stated: "On the other hand, the depressing influence on entrepreneurs of their greater burden of debt may partly offset any cheerful reactions from the reduction of wages. Indeed, if the fall in wages and prices goes far, the embarrassment of those who are heavily indebted may soon reach the point of insolvency, with severely adverse effects on investment. Moreover, the effect of a lower price-level on the real burden of the National Debt and hence on taxation is likely to prove very adverse to business confidence." (Keynes, 1973: 264).

These effects become particularly important in the current context when countries in this situation face high private and public debts. Deflation, particularly wage-related, increases the weight of private and public debts, as well as debt ratios with regard to the GDP. This is undoubtedly the main trap that these countries have to face, when it is not even certain that, as I. Fisher pointed out, the efforts to reduce debt will not lead to its aggravation. This is the reason why the way he proposes is exactly the opposite, that is, inflation: "*… the ways are either via laissez faire (bankruptcy) or scientific medication (reflation), and reflation might just as well have been in the first place*" (1933: 349), given that inflation tends to cause the opposite effect, reducing the burden of debt and benefitting borrowers, including companies.

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[22] These effects may be further aggravated when wage deflation goes hand in hand with inflation in widespread and inelastic demand goods, such as energy, transport and food.

[23] This is aggravated by the impossibility to use budgetary policy in this context, which Blanchard suggested to make up for the negative effects of the wage deflation policy.

Given the reduction in disposable income and consequent increase in household debt burden, families reduce their expenses further or go into default, compounding the problems of the banking sector.

Similarly, companies producing for the domestic market with lower incomes, even in an environment of cost reduction, will also have greater difficulties to honour past commitments and maintain employment.

Governments also face greater difficulties in dealing with a situation where revenue is declining and the debt ratio is growing as a result of the reduction of the denominator.

The effects on the expectations of economic agents and investment are equally very negative and terribly constraining for growth and employment. The situation will tend to be further complicated if several countries simultaneously adopt the same domestic devaluation and promotion of exports strategy.

Thus, we have strong reasons to believe that the depressing effects on aggregate demand resulting from deflationary policies will be more important than what is usually admitted, and a deflationary spiral cannot be ruled out.

Clearly, while external devaluation tends to restore competitiveness and external balance at a level higher than that of the product, income and employment, domestic devaluation tends to restore the balances mentioned above at a level that is lower than those variables. Moreover, the path should be exactly the reverse, one of inflation, not one of deflation, but this choice does not depend directly on the Portuguese.

We therefore arrive at a particularly uncertain outcome. We do not know at what level of production, employment and quality of life the balances of public accounts and external balance will be attained, let alone if this balance will prevent Portugal from experiencing the explosion of debt recorded in Greece. However, we know that they will occur at a level lower than that of the product, employment and well-being of the population, at tremendous cost and unforeseen consequences.

4.5. Domestic devaluation and deflation. The experience

Unlike external devaluation policies, whose contours and likely effects were more or less established, domestic devaluation and deflation policies have not, so far, given us an experience leading to optimism.

When the gold standard was in use, deflation was used to adjust trade deficits. However, a recent World Bank (WB) study shows no ground for optimism, at least in modern economies. Not many episodes of sustained deflation can be found in the experience of 183 countries between 1980 and 2008, and therefore there are grounds for pessimism[24].

The results of deflation processes on competitiveness are not apparent, and are always associated with periods of reduced economic activity, often with long breaks and

[24] World Bank (2011) "Sovereign Debt and the Financial Crisis: Will This Time Be Different?" edited by Carlos Primo Braga and Gallina Vincelette.

subsequent list of loss of income, employment, productive capacity, and life standards[25].

The recent experience of Germany in the post reunification period appears to be more encouraging, as it went through a process of "wage planification". It is generally accepted that it had positive effects on the competitiveness of the economy, although other factors, such as ensuring a pattern of increasingly sophisticated industrial specialization, namely in luxury and quality products, may have weighed more than actually wage restraint[26].

Some authors note that the wage planification carried out by Germany was not without effects, albeit in the opposite direction, on the economies of other euro countries. "Excessive wage restraint in Germany will … put pressure on wages policy in other EU countries in the medium term. The fact that inflation in Germany is lower than the EU average means that the price competitiveness of German producers in the European market is constantly increasing" (Eckhard Hein *et al*., 2004).

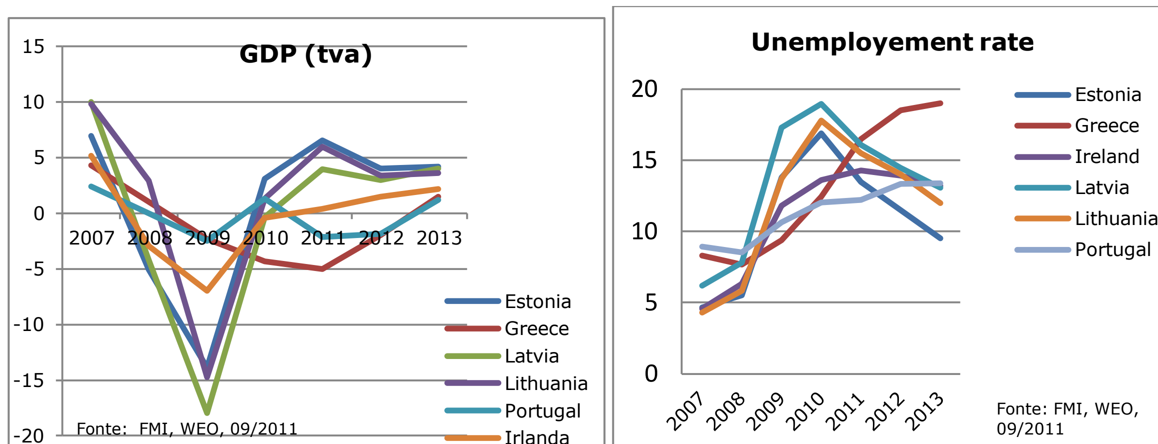
Wage deflation has recently gained popularity during the 2008-2010 recession, when several countries (Estonia, Latvia and Lithuania) used it in order to restore competitiveness and balance national balances. In the middle of the last decade, these countries have pegged to the euro, developing booms but losing competitiveness. With the 2008 crisis, the product fell sharply in those countries, which, nevertheless, kept the peg and implemented austerity measures. Their economies are now showing signs of growth supported by exports, following IMF intervention and a brutal drop in product.

The charts below show the evolution of the product (change rate) and of unemployment in the three Baltic countries, Ireland, Portugal and Greece. With regard to product, one notes a double trend in what concerns the course of the crisis. A V-path of the three Baltic countries and Ireland (less prominent) and a prolonged U-shaped path which, in Portugal's case, shows a counter-trend in 2010 as a result of an extraordinary expansionary policy that has contributed to the sharp deterioration of public accounts.

[25] Argentina, as peripheral countries, lost competitiveness when, in the 1990s, it pegged the peso to the dollar and held deflation for three years until the economy and pegging to the dollar collapsed. In the CFA (*Communauté Financière Africaine)* monetary area, the average inflation between 1986 and 1993 was 0.3%, and some countries experienced some deflation at the end of that period, but competitiveness was not restored, and major devaluation took place in 1994. In the Swedish economic crisis of the 1990s and on the occasion of Finland's accession to the EU in 1995, the results were also questionable.

[26] The European Union (2010) stresses that the dynamism of the German export markets almost completely account for the average annual growth of 7.3% of the volume of German exports between 1999-2008, while the contribution of the most competitive prices driven by wage restraints did not exceed 0.3% per year. The reason lies in the fact that German's industry specializes in products that the most dynamic emerging economies want to buy (luxury cars, machinery, computer equipment, transportation infrastructures, etc.). In this equation, prices come second.

Chart 4



The unemployment rates follow the same trend, with Portugal and Greece showing trends that point to aggravation, as a result of the dramatic increase of the last few months.

Experience indicates that it is not certain that lower wages in the peripheral countries of Europe will increase their competitiveness with regard to more competitive countries and to emerging countries with lower wages. What may occur is a mere phenomenon of competition among those countries, with the one that succeeds in imposing lower wages gaining the race. But, in terms of the sovereign crisis in Portugal and Greece, there is a factor that is often missing in former contexts and which has not properly been taken into account, and in which I insist: the debt level reached by those countries.

With no experience of using internal devaluation and deflation amidst widespread indebtness, and given the theoretical considerations previously advanced, it is not unlikely that a recessive deflationary spiral may cause social and political collapse.

5. The conditions for sustained growth

The profound question that subliminally worries minds in the peripheral countries of Europe is to know whether their countries are able to continue to be part of the cosmopolitan economics of the euro, i.e. if they can not only stabilize their economies but also come back to a path of growth that allows them to, at least, not to diverge. This is particularly important in the case of Portugal, due to the **growth anaemia** of the last decade, despite the very favourable conditions it enjoyed, the favourable external environment, extra funds from the EU, expansionary budgetary policies, and the absence of liquidity constraints.

5.1. Globalization, integration, growth, and convergence

With the *adoption of the euro*, all barriers to competition within this area have been abolished, thus creating the conditions for assessing the thesis advocated by the

dominant theories of international trade, according to which free competition necessarily results in everybody benefitting, particularly less competitive countries, in the same conditions as those in a gold standard system.

In fact, judging by the analytical results provided by the dominant economic theories, there should be no fundamental obstacles to the development of countries of southern Europe, even in the context of globalization and European integration. Indeed, the theories that lead to the defence of free trade as a fundamental result are well-established. Whether benefitting from the relative differences in productivity (D. Ricardo), from the differences in factorial endowments (Heckscher-Olhin-Samuelson), or by taking advantage of economies of scale or product differentiation, countries generally benefit by developing their trade relations with other countries.

Of course, this does not preclude that along with the benefits there may be costs associated with the production restructuring necessary to achieve those benefits. From the outset, between sectors, with the export sectors increasing production and competing sectors reducing it with imports (Ricardo and H-O-S), decline of more labour-intensive sectors and expansion of capital and/or skilled labour intensive sectors, as in the case of more advanced countries, with consequences on the redistribution of income, in principle in favour of the scarcer factor. On newer models, these results are not fundamentally questioned, although important "nuances" may occur. Some authors argue that the intensification of international trade brought about by globalization leads to the reallocation of resources among sectors and intra-sectors, encourages business development in companies with the highest productivity and the decline or closure of those with lower productivity across all export sectors, whether they have liquidity or not. In the opinion of some, this may generate earnings for all production factors[27].

This free trade optimism has long held a dominant position in economic literature[28], which does not exclude unconventional views on this matter, such as that of Friedrich List. This author, a precursor of the German Historical School that opposed the English Classical School, despite having been relatively overlooked by contemporary economic thinking, deserves to be remembered today because he challenges contemporary mainstream thinking.

List's analysis follows a historical and evolutionary perspective expressed through a definition of developmental stages, which leads to two results emphasized here using the author's words: *"(1) It was clear to me that free competition between two nations far advanced in culture could only have beneficial results if both stood at an equal industrial level;… (2) and that a nation which, by unhappy fate, was lagging much behind in terms of industry, trade, and navigation, but otherwise had the mental and material resources to have them, would first need to become capable through its own efforts before it could compete freely with more advanced nations. In a word, I discovered the difference between cosmopolitan economics and politics."* (List, 2006: 40).

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[27] For a summary, see Manteu, Cristina (2008).

[28] The situation is much less evident at the level of the economic policy of the international organizations, especially if we exclude communication and propaganda levels. The history of the GATT or of the WTO is both the history of the rise of liberal communication and that of the maintenance/institutionalization of obstacles to free trade of the dominant theory, and the beneficiaries of liberalization and protectionism are not difficult to detect.

However, F. List was not neither anti-European nor anti-globalization. He merely opposed the theory of value of the Classical School by advancing a theory of productive forces which states that the wealth of a country lies more in the potential and structural factors than on the value created at a given time, requiring the creation of a set of conditions prior to full competitive confrontation. "A nation like England, whose manufacturing strength placed it very much ahead of other nations, maintains and expands its supremacy in manufacturing and trade through trade as free as possible (List, 2006: 110).

This author also briefly exposed the alleged scientific neutrality of the classical thought.

"Hence the preference of enlightened English economists for absolute commercial freedom, and the aversion of sensible economists from other countries to implement this principle in the current world conditions" (List, 2006: 110).

Supporting his analysis on the strength of historical argument, the author recalled the guidance and outcome of the work of the Count of Ericeira as follows: "Portugal, thanks to the work of a strong and wise minister, was attempting to establish a manufacturing industry, whose initial success is amazing" (List, 2006: 190). He then contrasted the potential of Portugal's manufacturing development with the consequences of the Treaty of Methuen for Portugal. *"Immediately after this trade contract was agreed, Portugal was flooded with English goods. And the first consequence of this flood was the sudden and utter ruin of Portuguese factories*" (List, 2006: 192). "Portugal's agriculture, industry, trade and navigation, instead of increasing with the exchange with England, sank more and more*"* (List, 2006: 197).

This analysis of F. List makes sense when compared to subsequent well-known historical facts. Indeed, all the successes of less developed countries with regard to achieving a sustained rate of growth and real convergence of their economies, ranging from the industrialization of Germany to the new Asian newly industrialized countries (NICs) and to the current emerging countries, we realize that they always had an intelligent and skilful management of the various types of barriers (tariffs, non-tariff related issues, monetary issues) as a basis, combined with a prudent policy of openness

However, with the adoption of the euro, all barriers to competition within this area disappeared, creating all the conditions for an assessment of the thesis defended by the international trade dominant theories, which argues that free competition would necessarily benefit all, particularly less competitive countries, as conditions like the gold standard system would be restored. The question is whether the optimism of the Classical School will prevail, in practice, over the pessimism of the German School.

5.2. The theoretical and political constraints of integrated areas

The fact that the economic policy changes profoundly when a country waives its own currency to take on the currency of an integrated area does not need to be underlined. First, the loss of the exchange rate as a variable to adjust the economy to the outside world greatly limits the capacity to manage the economy and to maintain its external competitiveness. But the absence of an own currency also implies increased difficulty and restrictions in the management of credit and price policies, which limits the ability

to adjust the price variables with regard to future imbalances, whether domestic or external in origin.

Nominal wages turned into the only variable – flexible pricing - will not be able to provide an answer to asymmetric shocks except at the expense of painful deflationary processes and drops in social cohesion that may reach unpredictable proportions. That is to say: there are no socially and politically acceptable automatic mechanisms that can accommodate the necessary imbalances that naturally tend to arise in a growing economy.

It should be noted that the loss of sovereignty resulting from the decision to join a monetary area extends in a more or less direct way to other variables and to economic policy, limiting them more or less importantly, particularly in terms of budgetary policy. This has been much misunderstood by some countries, especially those with a tradition of persistent public deficits.

Under conditions of limited solidarity, budgetary policy within a monetary area tends to be conducted through rules, which in the case of the EU, are defined in the Stability and Growth Pacts (SGPs), which considerably limit discretionary policies. Usually, a path centred on a structural deficit of a certain amount is set. This means that *renouncing monetary sovereignty means accepting limited budgetary sovereignty.* Clearly, if the country has a debt and a high debt service, surely there will be no leeway for discretionary budgetary policy.

The only way to be able to conduct a discretionary budgetary policy, **which is the expression of a certain amount of sovereignty,** during a recession, is by keeping the budget balance and debt in their comfort zone, so that spending can be significantly increased during recessions. The budget balance emerges as a trend reference when one needs some room for budgetary sovereignty.

The state, insofar it impacted a significant amount of resources to the economy, will continue to play an important yet qualitative role, expressing different alternative choices in a long term (or almost) budgetary balance framework, at the same time that the nature and structure of the state should conform to the sovereignty restriction mentioned above.

By reducing the role of macroeconomic policy, both in terms of stimulating economic activity in general and in its stabilization role, growth (or rather, lack of it) becomes a problem that can be addressed solely from the perspective of microeconomics and mesoeconomics, substantially reducing the effect of economic policy. In terms of economic policy, this is the main consequence of the loss of monetary sovereignty.

5.3. Exports, growth and long-term balance in integrated areas

The absence of own currency prevents the exchange mechanism from restoring the balance between tradable and non-tradable goods, affecting resources between these two sectors. Therefore, there will be a tendency for cumulative effects to develop in either direction, depending on the economic structures and the policies of different countries. Countries with trade surpluses will tend to strengthen their production structure by investing more, getting more and better resources at lower prices, not only for export sectors but also for the entire economy, improving the very

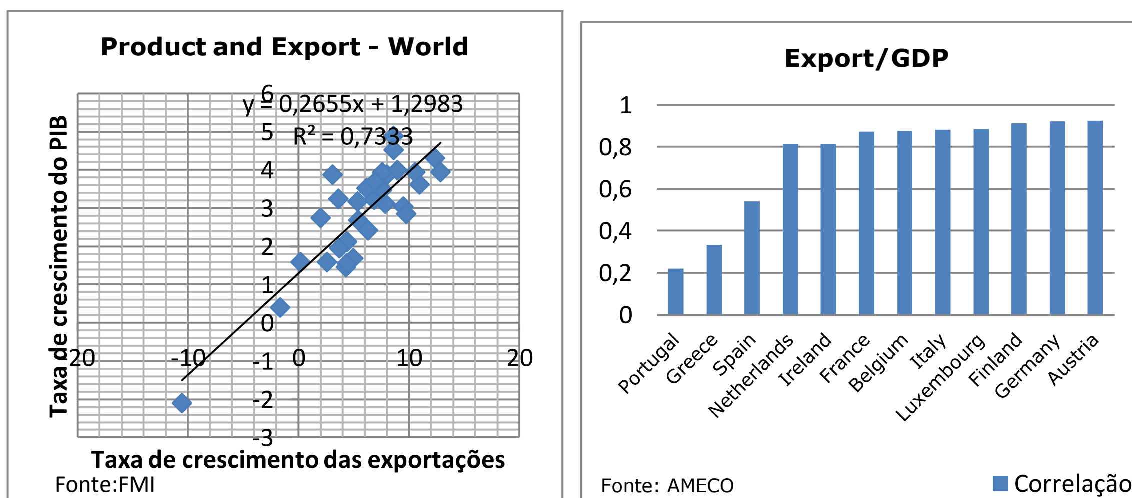
framework of the export sectors and their growth potential. On the other hand, countries that develop trade deficits, particularly small countries, tend to face often unfavourable prices set internationally, low incomes that contribute to inhibit the development of the production of tradable goods, growing difficulties in attracting quality resources and/or at acceptable prices, generating persistent imbalances and a worse situation, until a new crisis comes along to restore the lost balance. Of course, the process is identical in the situations that tend to occur within a fixed exchange rate system. However, there is one fundamental difference. Whereas in the latter system one can resort to currency devaluation before the imbalances become seriously exacerbated, in a single currency system this possibility does not exist. In this context, only crises will restore long-term balances, creating the conditions for the economy to get back on track. "*Crises are violent and momentary solutions to existing contradictions, violent eruptions that temporarily restore lost imbalances*" (Marx, 18. 1976).

Naturally, imbalances will tend to arise spontaneously as the result of economic dynamics, although their amplitude can extend (as was the case of Portugal and Greece), or shrink depending on the policies implemented. On this matter, it is essential not to contribute so that excess of expenditure, namely state expenditure, expands imbalances. Social and wage expenditure should take into account the over-determination mentioned earlier and evolve according to the growth of national production. It can exercise some pressure on the latter, but it continually cannot move away from it.

An important consequence in terms of analysis must be stressed. In the long term, the tradable goods sector sets the pace for the production of wealth and all other sectors. The growth potential of the economy depends mainly on the potential growth of the tradable sector.

The strong relationship between economic growth and changes in exports is well known, with a strong correlation (0.86%) in the world, showing also significantly in the chart below (on the left). This correlation is equally very strong in most countries of the euro (12), with the exception of Portugal, Greece, and Spain, as can be seen in the chart on the right.

Chart 5



But what I really want to emphasize is that characteristically, in an economy without its own currency, the rate of growth of the long-term balance of the economy tends to be determined by the exports rate of growth. Similarly, the evolution of average wages cannot fail to be in line, in the long term, with the evolution of productivity and wages in the export sector. The capacity to develop a high value-added export model will decide if it will be possible to get the Portuguese economy closer to more developed ones.

This result is associated with a profound alteration in the nature and size of the instruments that governments can use to support the economy, making them basically dependent on themeselves. I refer to endogenous growth factors, such as territory and resources, population and knowledge, character and initiative, individual and institutional preferences, etc. In particular, policies aimed at investment, particularly foreign direct investment, are crucial. However, "*Instead of broad spectrum policies to attract investment…it is preferable to adopt specific measures, selectively targeted and focused on more interesting targets, particularly projects that produce exportable goods and services in Portugal*…" (Pinto: 252).

In any case, all policies must serve a clear strategy. Only the development of sophisticated strategies and business operations, especially in the tradable goods sectors, and individual and institutional preferences in favour of national production will, together, create renewed conditions for the sustainable growth of the Portuguese economy. Although not necessarily guaranteeing any real convergence of the Portuguese economy, such strategy is a necessary condition to avoid the stagnation that characterized the last decade of the Portuguese economy and avoid a continuous impoverishment that a burden of debt and interest seems to have sentenced us.

Less indirect influence of the state in the economy does not mean its total impossibility to influence some exogenous factors. It means that the opportunity to allocate resources to areas that can stimulate growth now depends very significantly on the size and quality of the state and its sectors[29], and that the capacity to influence many of the endogenous factors, such as capacity and entrepreneurship and certain individual and institutional preferences, depend on the development of strategies and imaginative and effective actions on the border of the community legal framework. This possibility gives particular emphasis to the need for a shift in demand for domestic production, which is unlikely to occur by simple automatic operation of market mechanisms. The Statesman has to know " how the productive forces of a whole nation are aroused, multiplied, protected, and what weakens them, makes them dormant, or even kills them…" (List, 1841/2006: 581).

6. Conclusion

The analysis of the economy over the past decades shows that the economy has progressed, but reveals some features that seem to remain part of our history for centuries. The pepper of the Indies, the gold from Brazil, emigrants' remittances, and

[29] An austere, small, and flexible state will tend, under the circumstances, to leave more room for social functions and investment carried out by the state, will limit corruption factors in its various forms, typical or mitigated, and will impose a more competitive tax structure.

external funding from Europe (structural funds and loans) have chiefly contributed to sustaining sumptuous spending, such as silk fabrics, monastery building, wars, or exuberant top of the range consumption. However, in the past as today, they were not used to create a production basis capable of maintaining sustained economic progress in accordance with the aspirations of the Portuguese.

The development in the last decade of an dangerous model of stagnation, imbalance and dependence, based on an insufficient level of production with regard to excessive consumption, funded from the outside, with explosive characteristics, very similar to the situation in many Latin American countries two decades ago, finally resulted in collapse when the conditions for funding the debt became unsustainable and the European Union declined unlimited solidarity.

This collapse has made paramount a stabilization policy marked by strong austerity, namely wage depreciation. However, this policy greatly underestimates the depressing effects on aggregate demand, particularly within a context of heavy debt, threatening to drive the economy into a deflationary spiral that could undermine the very objectives of budgetary consolidation and thus threaten social and political stability. Accordingly, neither the theory nor the much limited experiments help clarify the ways ahead. Whether the Portuguese economy will find the path of recovery or simply tangle in a recessionary spiral that will lead to stagnation and depression is a key issue with a simple answer: we do not know.

The conditions for sustained growth and real growth in peripheral countries in the euro zone have become a key issue, particularly after the anaemia of growth in the last decade, despite the extremely favourable conditions it enjoyed, both in terms of the general situation and international funding and of the domestic expansionary policies. The recent evolution of the Portuguese economy, but also other international experiences, seem more in line with the pessimistic view of F. List on the negative consequences of the full removal of barriers to competition among countries with very uneven productivity levels and development than with the optimistic views advocating the advantages of free trade in all circumstances.

Within the euro framework, with no monetary policy and with a budgetary policy conducted by rules, discretionary budgetary policy is only possible within a very narrow bandwidth, through the creation of a comfort zone to be auctioned in times of recession. General economic activity finds no development room in macroeconomic policies, for which reason it should be encouraged resorting to microeconomic and mesoeconomic policies.

On the other hand, in the absence of a foreign exchange market, the growth of the export sector in the *long run* sets the pace for the production of all other wealth and sectors, while the evolution of productivity tends to serve as a reference for the wages of all the economy. Public wage and social contention policies, as well as the presence of a state strict in its structure in order to keep the scope of its duties, become necessary to prevent the expansion of the imbalances that the economic dynamics tends to generate, which, in the absence of price systems that correct them, these imbalances will inevitably be corrected by the crisis.

The adoption of a national economy viewpoint promoting the stimulation of endogenous factors that attempts to reap the benefits of the European Union to maintain a route of progress is indispensable, despite the fact that EU policies are not always convergent

and appropriate to our particular situation. The construction of an export economy model with high value-added is a necessary strategy for the stable growth of the product, wages and welfare. Making this aspiration possible is the challenge that the authorities, businessmen and Portuguese workers will need to address. If this path does not ensure real convergence of the Portuguese economy, it will allow keeping it a member of the club of rich, even if with declining growth and misguided policies.

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