The Central Role of Structural Reforms in Boosting Portugal's Economic Program

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Workshop on Structural Reforms In The Context Of The Adjustment Program

Lisbon, January 21, 2012

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Thank you for the opportunity to speak here. There have been many interesting and perceptive presentations at the workshop in the past two days, which should greatly help in strengthening the reform program. I would like to focus on some of the structural reforms, in particular those relating to improving price competitiveness and supporting the fiscal consolidation effort.

As has been discussed, Portugal's economic imbalances increased significantly after its entry into the euro area, ultimately forcing the Portuguese authorities in May 2011 to put in place a program supported by the European Union (EU) and the International Monetary Fund (IMF). Over the last decade or so, debts in all sectors have increased a lot, which one would think should be associated with strong growth, the latter has in fact stagnated. Why?

Basically, Portugal left the vast growth opportunities of EU and euro area membership unexploited. In the absence of serious structural reforms, Portugal could not exploit the growth opportunity offered by the availability of relatively easy and cheap funds for financing productive investments. Instead higher public and private debts effectively supported consumption-based growth. As a result, the more profitable but less growth-generating non-tradable sector grew, with labor cost and prices fueling a significant real exchange rate appreciation that undermined the country's external price competitiveness and exports.

It is clear that this unsustainable process of higher debts and lost competitiveness should be reversed. We know there has to be fiscal consolidation. We know there has to be private sector deleveraging. But the important point is that **if the aim is only to cut spending and deleverage balance sheets, the program will fail**. That is why structural reform to boost growth and productivity has to play a central role. Remember the alternative to achieve equilibrium is for purchasing power and earnings to fall over time, i.e. for Portugal to become poorer, to match lower productivity growth. This would be a highly undesirable outcome.

There are many aspects to reforms and my colleagues from the European Commission and European Central Bank have touched on many issues already. **I will discuss only two areas: the need to boost external price competitiveness; and the need to support fiscal adjustment through structural fiscal reform.**

Price competitiveness

As has been discussed extensively, Portugal's lack of price competitiveness, or if you like non-tradable prices that are too high relative to tradable prices, are an important source of low exports and low growth. Now, in a country outside a monetary union, exchange rate devaluation could help. But that is not possible here. That is why we proposed a fiscal devaluation, based on the ideas at that time already floating around in various circles in

Portugal itself. The idea, as you know, is to mimic a regular devaluation by lowering social security contributions in a fiscally neutral way by increasing indirect taxes, in particular VAT, or cutting expenditure. This would, assuming profit margins in the nontradable sector do not increase, improve relative prices in favor of exports and encourage more tradable activity. The measure could be complemented by buffers to protect the poor and minimize fiscal risks.

However, the authorities felt that the timing was not right given the ongoing fiscal adjustment. We of course respect their view but hope that this can still remain on the agenda.

Let me also note here something that I consider quite important. A devaluation of any sort can only jump start the process and help reform, but in the end has to be supported by fundamental reform. Otherwise relative prices may get back to where they were over time. There should not be any illusion. However, the important point is that without devaluation the process is much harder and reliance on very difficult reforms becomes much more immediate and urgent. The experience of Portugal under the IMF programs of the 1970s and 1980s illustrates this point. While some of the measures in the budget should help in this regard, obviously much more is needed.

Now what type of reforms do we have in mind? I would like to stress two areas: domestic competition and labor markets, both with the idea of putting downward pressure on non-tradable prices, through a reduction in the profit margin in largely uncontested industries and through a moderation in the cost of labor. **In both of these areas the idea is to create level**

playing fields and equal opportunities for all, enterprises and workers alike. As experience in reform in other countries and reform under other IMF programs suggest there is no option but to reduce rigidities and put the economy on a higher growth path.

Fortunately, while many challenges remain, the program is off to good start in both areas, in light of strong commitments by the government and support by social partners. Let me give a couple of examples.

The competition framework is being substantially strengthened. The Competition Law is being revised to be harmonized with EU laws and strengthen the powers of the Competition Authority. Opening up the nontradable sector is key and important progress has been made in the telecommunications sector. But more work is needed in the energy sector, where the authorities have committed to prepare specific proposals for further action in this area.

Turning to labor markets costs to firms of dismissing workers (among the highest in the OECD) have been reduced substantially. **This should provide more opportunities** for unemployed workers. Reform of wage setting mechanisms, in particular collective bargaining agreements, will further help reduce unemployment and enhance productivity. The authorities' commitment not to grant automatic extension of collective agreements in 2012 should reduce wage pressures in firms where such pressures are not consistent with their economic situation. I also welcome the recent agreement reached with social partners and labor unions to promote growth, competitiveness, and employment, and hope this will strengthen the program further.

Let me also stress here that to encourage tradable activity, it is also hugely important that the deleveraging process allows sufficient credit to these dynamic sectors.

Let me now turn to the second area of reform I mentioned, namely structural fiscal reform. Here again the Portuguese economic program includes a far-reaching agenda, primarily designed to help achieve the fiscal consolidation goals in an efficient and least disruptive way. These have already helped the fiscal adjustment in 2011. The plans are aimed at streamlining the public sector, including by minimizing bureaucracy and waste of resources, and increasing the effectiveness of the country's fiscal institutions. Let me discuss three key areas: (i) strengthening public financial management; (ii) modernizing revenue administration; and (iii) reforming state-owned enterprises and Public-Private Partnerships (PPPs).

On Public Financial Management (PFM) reform, the first objective is to *improve budget planning and execution*. The new budget framework law adopted last year for instance is a significant step toward improving medium term budget planning. Another important measure is the creation of the fiscal council. The second main objective is to *regain control over expenditures*. The authorities are in the process of modifying the legal framework to: (1) prevent spending units to enter into commitments in the absence of available funds; and (2) disallow the payment of expenditures outside the commitment control system.

Revenue administration reform. This is an area where Portugal fares relatively well compared to other countries. Still the Portuguese authorities have opted for an ambitious reform agenda, which includes the merger of the tax, customs and IT services.

State-Owned Enterprises (SOE) and PPP reform. Both SOEs and PPPs have been the source of fiscal risks that have contributed to the deterioration in public finances. The reform therefore aims at streamlining the government enterprise sector by improving its cost-effectiveness, focusing the state participation on essential public services, and reducing fiscal risks.

Let me note that while these reforms are crucial to facilitate the fiscal consolidation process and could be costly in terms of short-run growth, they will help improve long-terms growth prospects. This is through improved confidence resulting from fiscal sustainability, better allocation of resources, and improved business environment through improved tax administration. More efficient resource allocation will also help improve targeting of social programs and mitigate the impact of the consolidation efforts on the most vulnerable.

Let me conclude by congratulating the authorities for the strong start to the program and note that we share their view that clearly this is just a start and many challenges remain. We welcome the authorities' plans, for example through these workshops, to further strengthen the structural reform agenda in focus and specificity. Thank you very much.