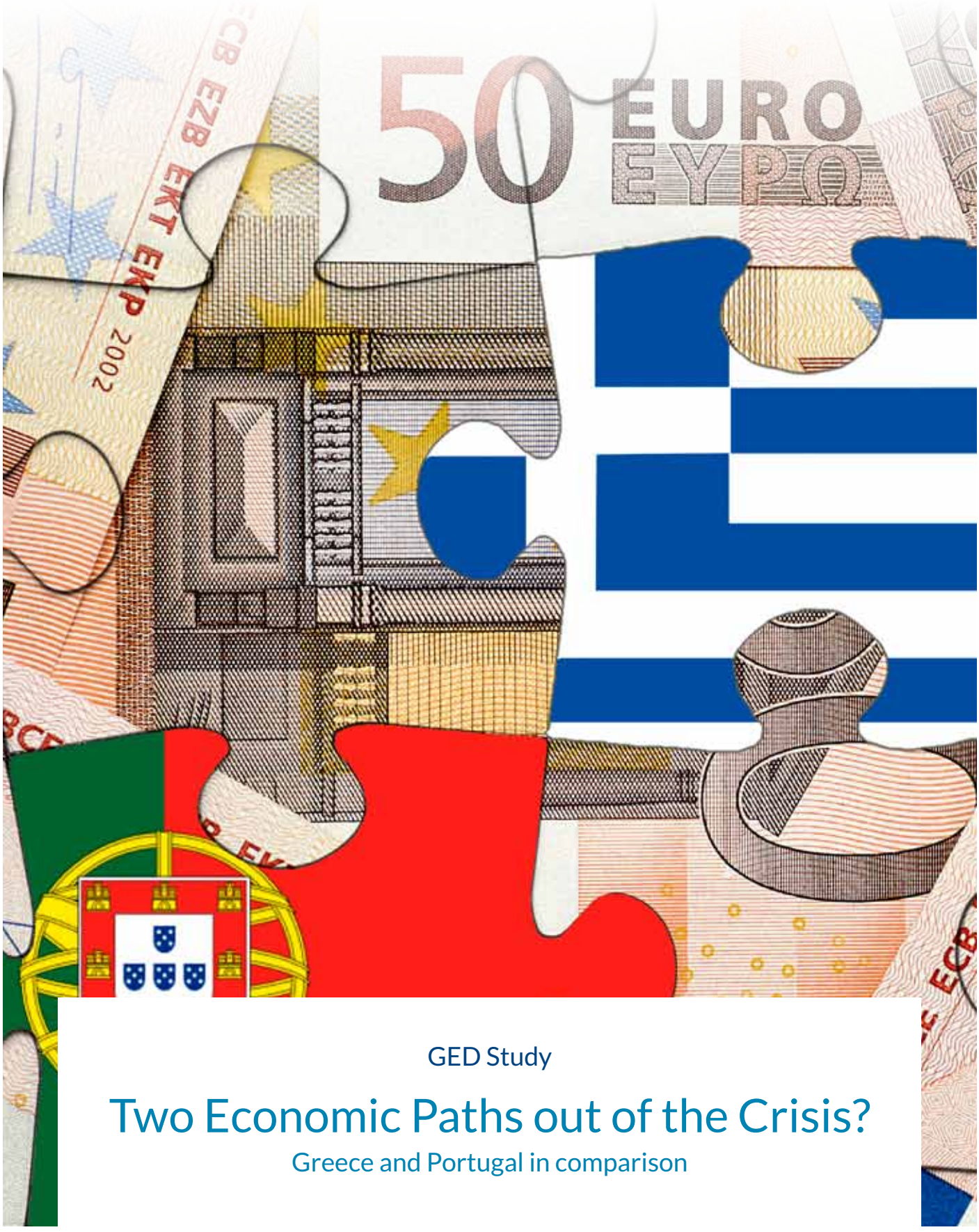
GED
Global Economic Dynamics



GED Study

Two Economic Paths out of the Crisis?

Greece and Portugal in comparison

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The programs

Both Greece and Portugal are small, open economies with similar population figures (Greece approx. 11 million and Portugal approx. 10.5 million), integrated into a common currency area – the euro.

Following the 2008 world financial crisis, Greece and Portugal lost their ability to obtain international market funding. They were thus forced to ask for a financial assistance program. These programs were intended to correct fiscal and external imbalances and restore confidence.

In October 2009, when the newly elected socialist government in Greece announced that the country's debt and deficit figures had been understated, budget deficit rose from an estimated 7% to more than 12% of GDP. Investors soon showed their distrust in Greece, and the yield spread of Greek sovereign bonds toward the Bund widened sharply.

Greece was the first Member State of the European Union (EU) to require financial assistance. Traditionally, developing countries that require financial assistance receive it from the International Monetary Fund (IMF). In this case, the assistance was agreed between Greece and the three creditors of „the Troika": the IMF, the European Central Bank (ECB) and the European Commission (EC). Greece signed the first Financial Assistance Programme amounting to €110 billion in May 2010.

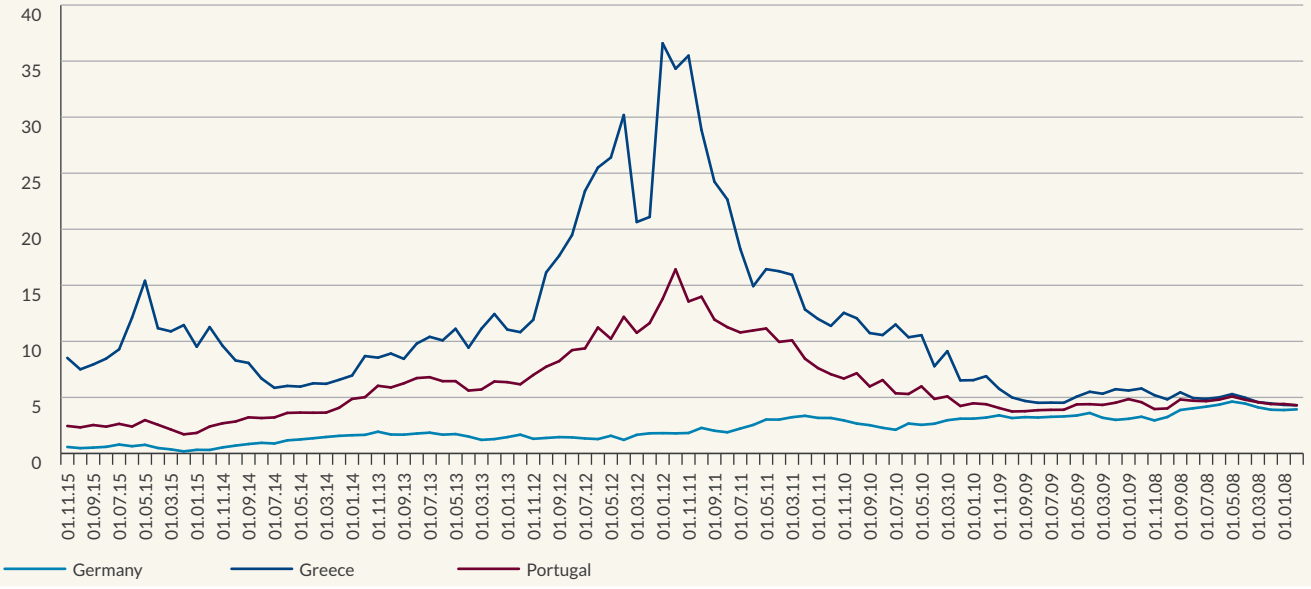
During the second Financial Assistance Programme, the anti-austerity party Syriza won the Greek national elections. The lack of agreement between the new government and the creditors culminated in the country's default on an IMF loan in June 2015. After a period of intense negotiations, an agreement was reached in July 2015, preventing a "Grexit" (the exit of Greece from the eurozone).

In August 2015 the EC and the Greek government signed a Memorandum of Understanding for a third Financial Assistance Programme, worth up to €86 billion. The program has the purpose of "restoring fiscal sustainability, safeguarding financial stability, fostering competitiveness and investment as well as promoting a modern state and public administration." Structural reforms are expected to yield Greece 0.75% of GDP in 2017 and 0.25% of GDP in 2018.

Before asking for international financial assistance, Portugal had already been suffering from increasing market pressures on its sovereign debt. Successive downgradings by credit rating agencies made it unsustainable for Portugal to finance itself in the markets, as happened in Greece. The banking sector, which depends to a large extent on international funding, was having increasing difficulties obtaining it.

Portugal requested assistance in April 2011. The Memorandum of Understanding for the Financial Assistance Programme for Portugal was agreed in May 2011 and amounted to €78 billion. In June 2014, Portugal ended the program without receiving the final tranche of €2.6 billion in assistance. It made early repayments to the IMF in March and June 2015 amounting to €6.6 billion and €1.8 billion respectively (so 28.1% of the IMF loan is now paid).

FIGURE 1 **Ten-year sovereign bonds yields**



Source: Investing.com, Accessed 07-12-2015

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FIGURE 2 **Financial Assistance Programmes**

Country	Period	First Financial Assistance Programme	Amount
Greece	May 2010	First Financial Assistance Programme	€110bn
	March 2012	Second Financial Assistance Programme	€164.5bn
	February 2015	Government requested an extension	–
	August 2015	Third Financial Assistance Programme	€86bn
Portugal	May 2011	First Financial Assistance Programme	€78bn
	June 2014	Exited the Programme	–
	March/June 2015	Repayments to the IMF	€8.4bn

The disbursement of funds from Financial Assistance Programmes requires the implementation of structural reforms, financial and fiscal measures. Austerity policies were "prescribed" to both countries. Both countries agreed to implement financial measures, fiscal measures and structural reforms.

The Financial Assistance Programmes (together with the Irish program) were atypical due to their long duration and the large size of the financial assistance packages.[1]

1 Pisani (2013)

Which factors led these countries to require financial assistance?

Prior to the 2008 financial crisis it was already clear that Portugal was following an unsustainable growth path: "Portugal faced an unusually tough economic challenge: low growth, low productivity growth, high unemployment, large budget and current account deficits."[2]

The reasons that led both Portugal and Greece to a default are, at the core, similar:

(i) Weak competitiveness due to low productivity and high unit labor costs;
(ii) Rigid labor as well as product markets; and
(iii) Persistent large external deficits and budget deficits.

Nevertheless, the paces at which the required reforms were implemented in each country were not alike. Already in 2013, it became evident that Greece was not implementing several of the contracted reforms.[3] In 2015, following the end of the program, the EC stressed that Portugal had started to slacken its consolidation efforts.[4]

It is also important to highlight the fact that both adjustment programs occurred when the EU was facing a recession.

Were the programs well-designed in the first place?

The programs for both Portugal and Greece were designed according to overly optimistic forecasts for adjustment and recovery. Therefore, unemployment rates increased considerably more than expected.[5]

Macroeconomic forecasts for Greece in the first program were highly inaccurate and debt-to-GDP ratios increased substantially more than expected. Speculations about a possible Grexit, talks on a possible debt restructuring and non-implementation of several reforms due to political agendas might have played a role. Furthermore, the external macroeconomic environment was also worse than expected. Overall, the program was robustly designed.[6]

On the contrary, markets had a more positive perception of Portugal due to i) domestic consensus in favor of the Troika program, ii) "the perception of a high degree of mutual understanding, trust and close cooperation between the Portuguese authorities and the Troika," and iii) because markets believed Portugal would exit the program on schedule and, if needed, would receive a credit line.[7]

Some measures contained in programs might also not be implemented due to institutional factors. In the case of Portugal, the Constitutional Court ruled out cuts to public sector pay and other austerity measures, claiming they would breach the Portuguese Constitution.

2 Blanchard (2007)
3 Financial Times (2013)
4 European Economic Forecast Autumn 2015
5 Pisani (2013)
6 Pisani (2013)
7 Pisani (2013)

Portugal a success, Greece a failure?

GDP growth – Did these countries start to recover from the major sovereign debt crisis?

Portugal is often described as a success story, having completed its Financial Assistance Programme without receiving its last tranche:

Portugal's reform efforts have paid off. Today's decision by the government in Lisbon is proof of this. Portugal no longer needs European assistance and can stand on its own two feet again. This is a major success.[8]
Wolfgang Schäuble

On the other hand, Greece has undergone two adjustment programs and is thus often perceived as a negative example. The newly elected government intended to finish the agreed budgetary consolidation policies. However, efforts culminated in the termination of the second Financial Assistance Programme for lack of agreement with its creditors.

Since this [Greek] government took office, the situation has consistently got worse, and it gets worse by the day and by the hour.[9]
Wolfgang Schäuble

Thus, in August 2015, Greece signed a Memorandum of Understanding for a third Financial Assistance Programme. Süddeutsche Zeitung has recently reported that creditors are denying Greece the disbursement of a €2 billion bailout tranche due to lack of progress on reforms.[10]

Is it really that simple to pass judgement on the success of the respective programs?

Let's take a closer look at the main macroeconomic indicators of both countries.

Following consecutive GDP contractions since the beginning of the world financial crisis in 2008, Greece's annual GDP growth registered a positive result in 2014 (0.6% growth), a current account surplus and a primary surplus of the state budget (in 2014).

The Portuguese economy started to recover in 2013. The economy has been growing since the last quarter of 2013, following 11 consecutive quarters of negative growth.[11] Current account surpluses have been also achieved since 2013.

Over-reliance on domestic demand seemed to be one of both Greece and Portugal's structural problems. A turnaround in the export sector could, thus, help to offset the negative consequences of austerity policies which require governments to cut spending and/or increase the tax burden.

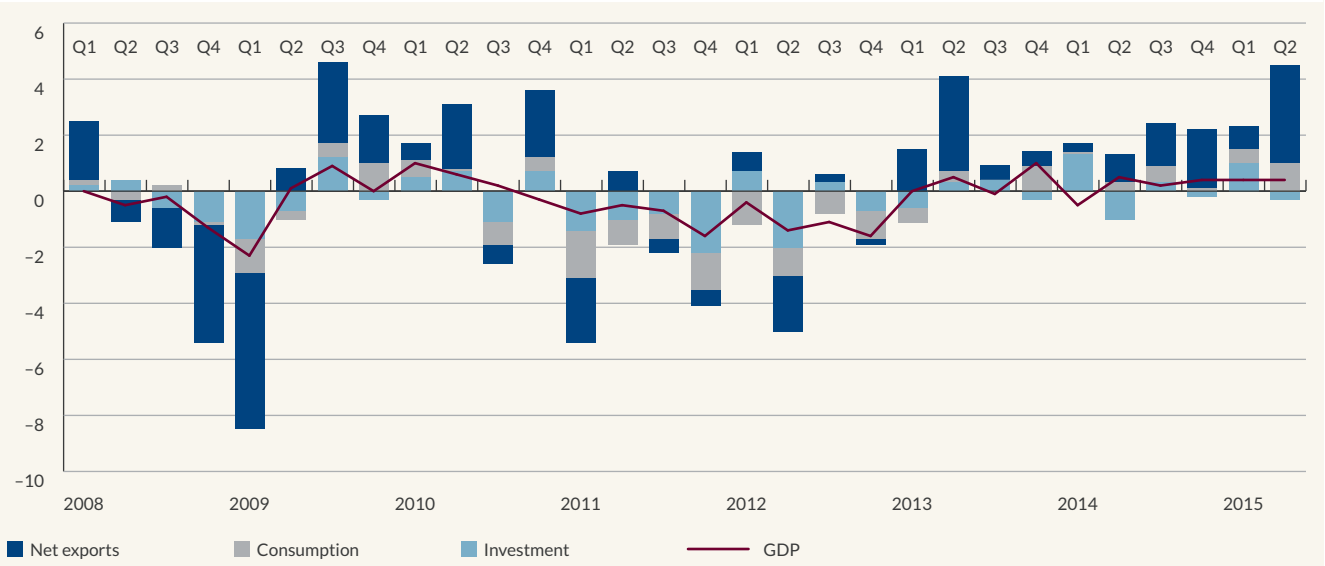
In Portugal the domestic demand fall was offset by an increase in net exports. The weight of exports in the GDP (Gross Domestic Product), from 2008 to the first semester of 2015 increased by ten percentage points (from 31% to 41%).

Moreover, a shift of resources from the non-tradable sector to the tradable one is noticeable. In this context, companies dedicated to exports have been gaining market quotas, while the construction sector has been contracting both in gross value added weight and in employment terms.

However, Portugal's recovery is being primarily driven by domestic demand, while external demand has been playing a diminishing role.[12]

8 Bundesfinanzministerium (2014)
9 Financial Times, "Schäuble eyes an opportunity in Greece's crisis"
10 Süddeutsche Zeitung
11 Macroeconomic Imbalances Country Report – Portugal 2015
12 European Economic Forecast Autumn 2015

FIGURE 3 **Contributions to q-o-q volume growth of GDP in Portugal – by expenditure component (%)**



Source: European Central Bank, Accessed 16-10-2015

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External imbalances can be tackled through a reallocation of resources from low-productivity non-tradable activities to the tradable sector.[13] In Greece, during the pre-crisis period, the labor resources allocated to the non-tradable sector increased by five percentage points (from 38% to 44%).

Exports in Greece have not shown a consistent positive trend since the beginning of the sovereign debt crisis. Both countries registered a disappointing investment recovery.

Forecasts from the EC persistently predicted a less deep recession, and better unemployment figures. The ongoing shift of production from the non-tradable sector to the tradable one means job destruction in sectors characterized as labor-intensive, such as construction and restaurants.

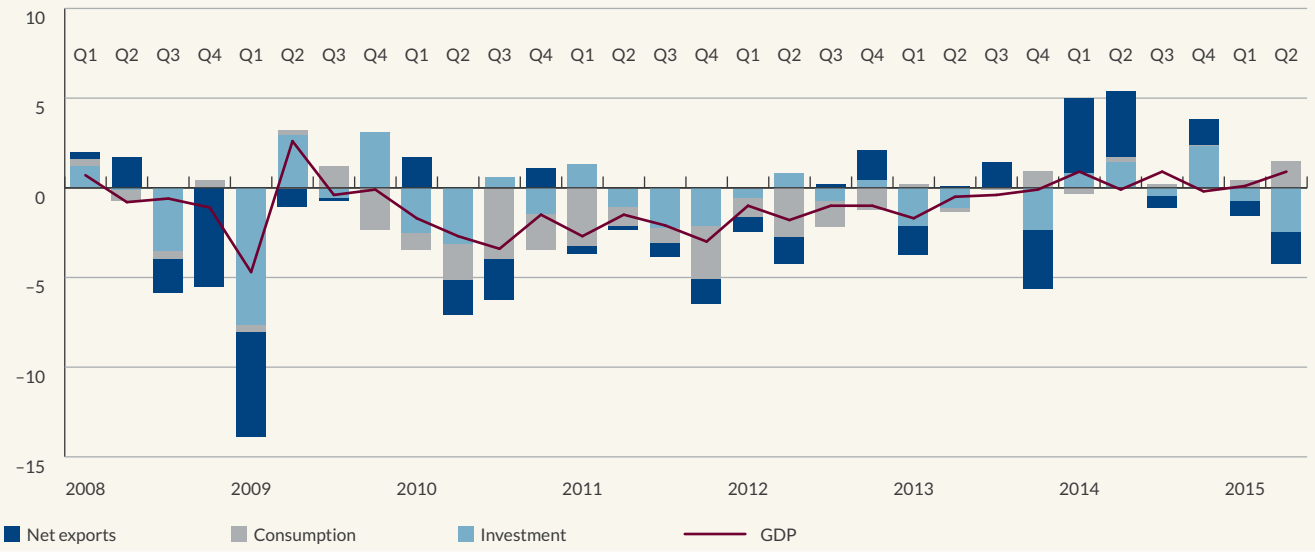
On the contrary, the current account performed better than expected. This better-than-expected external adjustment was due to both an increase in exports but also a decrease in imports.

Both Portugal and Greece have high percentages of shadow economies compared to the European average (18.5%). An increase in the size of a shadow economy is particularly worrying when governments need to tackle their public deficit. It can lead to lower state revenues, thus resulting in an increase in tax rates for those in the official economy.[14]

13 http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee5_en.pdf

14 Schneider (2002)

FIGURE 4 **Contributions to q-o-q volume growth of GDP in Greece – by expenditure component (%)**



Source: European Central Bank, Accessed 16-10-2015

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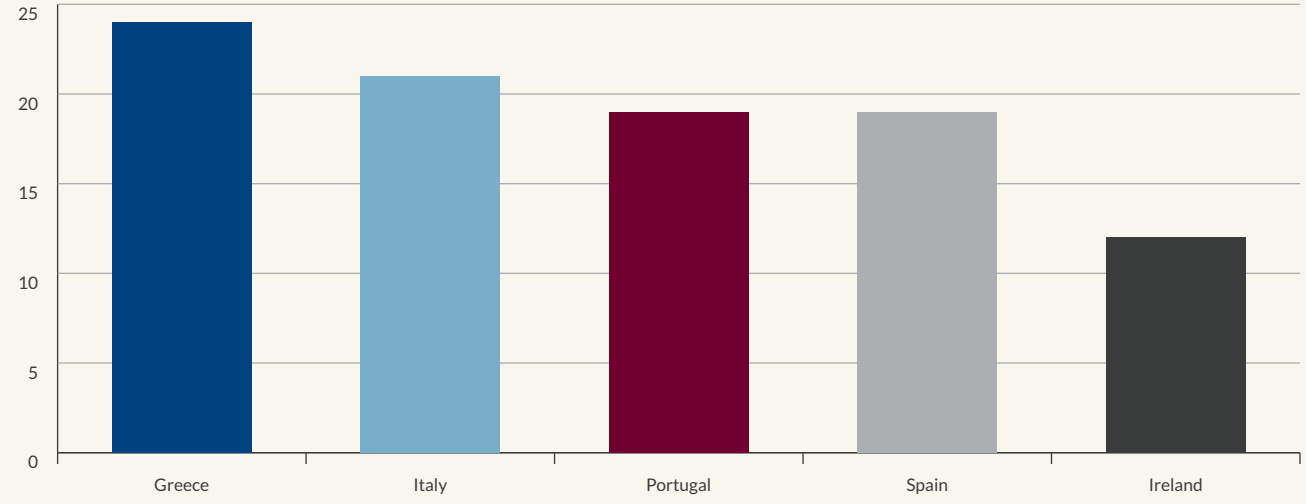
FIGURE 5 **Selected macroeconomic indicators for Portugal**

	Economic Adjustment Programme June 2011				European Economic Forecast Autumn 2015			
	2012	2013	2014	2015	2012	2013	2014	2015
GDP (annual change)	−1,8	1,2	2,5	2,2	−4	−1,1	0,9	1,7
Unemployment (%)	12,9	12,4	11,6	10,6	15,8	16,4	14,1	12,6
General Government deficit (% GDP)	4,5	3	2,3	1,9	5,7	4,8	7,2	3
General Government debt (% GDP)	107,4	108,6	107,6	105,7	126,2	129	130,2	128,2
Trade balance of goods (% GDP)	−5,9	−4,7	−4	−3,3	−5	−4	−4,6	−4,6
Current account balance (% GDP)	−5,2	−3,9	−3,1	−2,2	−2	0,7	0,3	0,5
Net lending / net borrowing (% GDP)	−3,7	−2,4	−1,6	−0,8	0	2,3	1,7	1,9

FIGURE 6 **Selected macroeconomic indicators for Greece**

	Economic Adjustment Programme May 2010		European Economic Forecast Autumn 2015	
	2012	2013	2012	2013
GDP (annual change)	2,1	2,1	–7,3	–3,2
Unemployment (%)	15,2	14,8	24,5	27,5
General Government deficit (% GDP)	4,9	2,6	8,8	12,4
General Government debt (% GDP)	149,7	148,4	159,4	177
Trade balance of goods (% GDP)	–22,6	–22,4	–10,9	–10,5

FIGURE 7 **Shadow economy figures**



Source: A. T. Kearney

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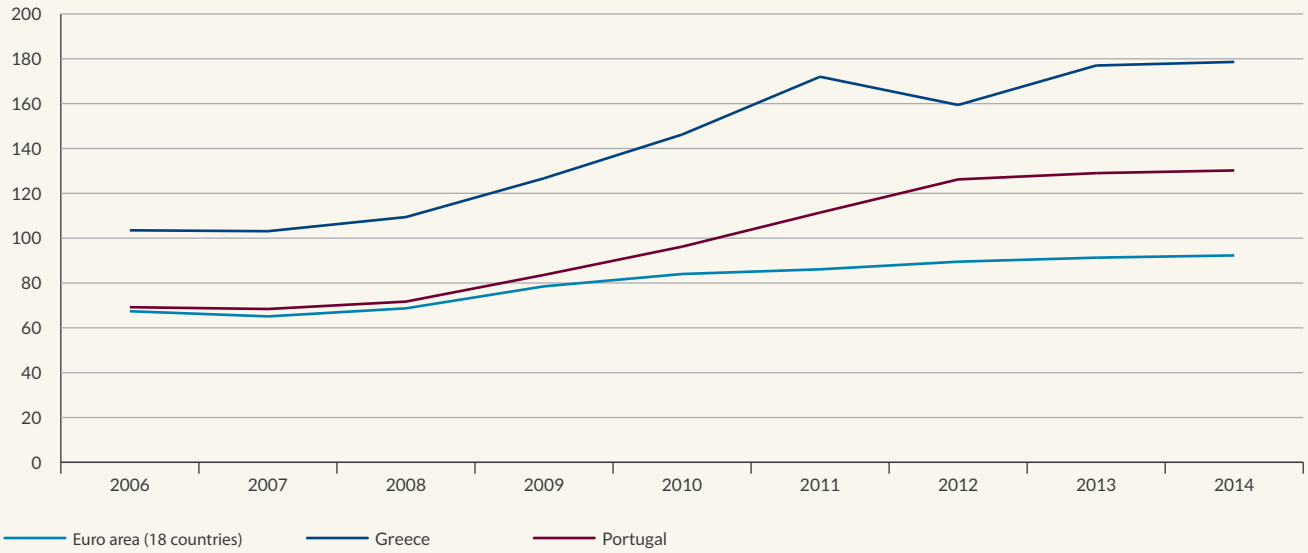
Worrisome debt levels

FIGURE 8 **General government consolidated debt (% of GDP)**



Source: Eurostat, Accessed 01-12-2015

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Public indebtedness has exploded in recent years in both countries. The steepest increases occurred during the 2008 – 2011 period. Greece scores the highest public debt rate in the EU, while Portugal comes third (after Italy).

Corporate sector indebtedness is especially worrisome in Portugal, where it peaked at 127% of GDP in the second quarter of 2014, considerably above Greece's 68%. The Portuguese corporate sector is mainly composed of small- and medium-sized enterprises (SMEs), which have been facing tighter credit supply conditions with higher interest rates than larger firms. In Portugal, in order to tackle corporate debt and insolvencies, two programs were implemented to allow the early rescue of viable firms.[15]

Fiscal measures

15 IMF (2015)

Is investment hampered by debt overhang?

Slow recoveries from financial crises tend to be characterized by debt overhangs and low investment rates.[16] A debt overhang occurs whenever the existing debt is larger than the stock of debt that the public sector is willing and able to service at market terms.[17] Greece is one such example. In the early hours of 27 October 2011, eurozone leaders and the IMF came to an agreement with banks to accept a partial write-off of a Greek debt. Greece, where the eurozone's debt crisis erupted in late 2009, is the currency area's most heavily indebted country, despite a major „haircut" on privately held bonds in the past.[18] The existence of a large debt overhang might be interpreted by investors as a potential future tax burden on the economy. Furthermore, as noted earlier, any increase in the shadow economy can lead to lower state revenues, thus leading to an increase in tax rates for those in the official economy. Therefore there will be fewer incentives for the private sector to invest.

The private sector needs to deleverage its balance sheets, leading firms to pursue debt minimization instead of profit maximization. This might lead to a deflationary spiral since aggregate demand falls proportionally to the saved but unborrowed amounts (balance sheet recession).[19]

In Greece, the level of investment in gross fixed capital formation (GFCF) by the corporate sector is significantly lower than the eurozone level, while the investment made by the general government is considerably higher. Portugal's investment by the general government reached a peak in 2010, one year before the start of the Financial Assistance Programme. These investments were part of the socialist government's fiscal measures to create jobs.

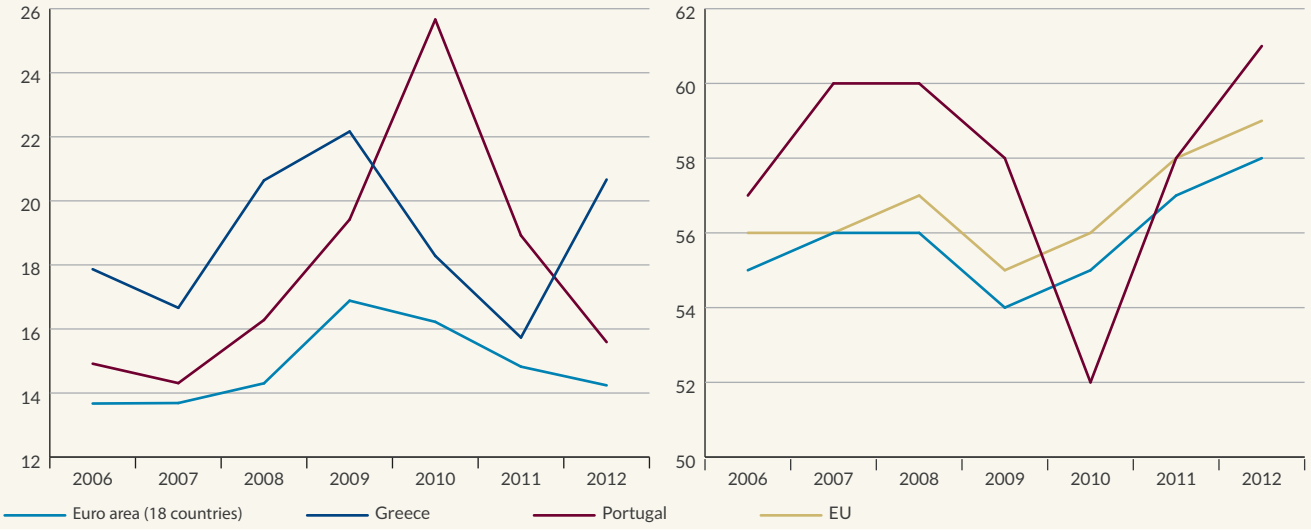
According to the banking survey conducted by the ECB, in the third quarter of 2015, credit standards for loans to non-financial corporations tightened in Greece. The Greek banks are facing difficulties in accessing money markets and show concern regarding the risks emanating from the overall economic situation and the prospects of the Greek economy. No improvement for the last quarter of 2015 is expected.[20] In Portugal, the survey found that, overall, the credit standards will not suffer any change. Nevertheless, a minor reduction in the restrictiveness of loans to SMEs might occur.[21]

Banking fragmentation in the eurozone remains a reality. Ceteris paribus, companies based in Portugal or in Greece still pay, on average, higher interest rates to access loans.

Ultimately, economic and political uncertainty undermine investors' confidence.

16 Döhring (2015)
17 Montiel (2003)
18 Reuters
19 Koo (2013)
20 Bank of Greece
21 Bank of Portugal

FIGURE 9 AND 10 **Investment in GFCF % of GFCF, 2005–2012 by the general government and by the corporate sector**



Source: OCDE National Accounts at a Glance, Accessed 16-10-2015

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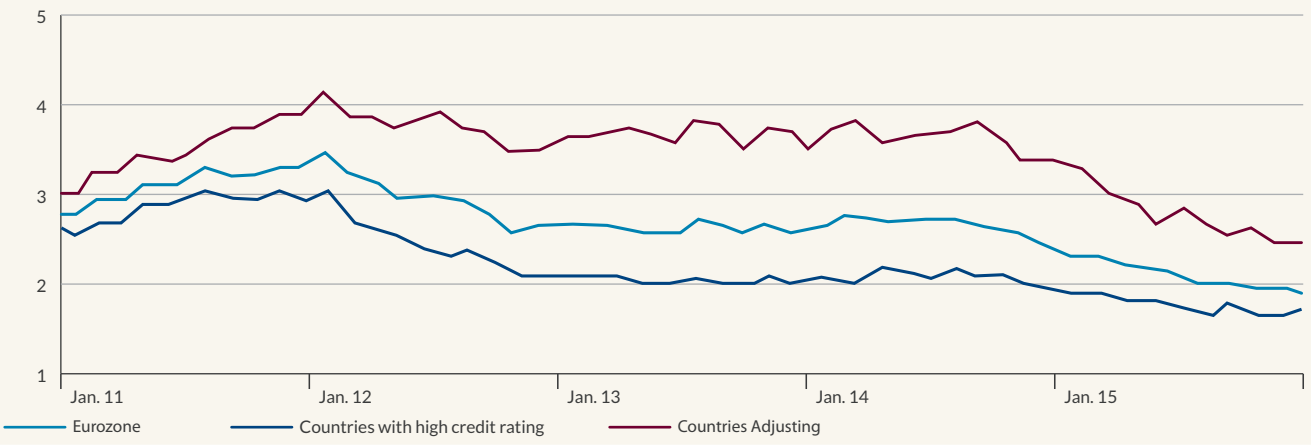
FIGURE 11 **Interest rates on new loans granted to non-financial corporations (%)**



Source: Bank of Portugal, Economic Bulletin October 2015

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Note: Countries adjusting include: Cyprus, Greece, Italy, Ireland, Portugal and Spain
Countries with high credit rating include: Austria, Belgium, Finland, France, Germany and the Netherlands

Exports as a pathway to economic growth?

Under the Financial Assistance Programmes the attempt to reduce government deficits, by both a decrease in public spending and an increase in the tax burden, will negatively impact the internal demand. Thus, the export sector can give a helping hand in offsetting the negative effects of the internal demand drop as a contributor for GDP growth, while re-balancing the country's external accounts.

Portugal "has managed to turn around its export performance in 2005, having regained the losses of the 2000s already."[22] Exports as a percentage of GDP have increased by almost ten percentage points from 2008 to 2014 (from 31.1% to 40%). Nevertheless, this figure is still below the eurozone average (43% in 2014). The recent adjustment of imports in Portugal (2011 – 2014) was mainly driven by income, but there was also a substitution effect of imports, which accounts for 10% of the adjustment.

Greek export performance has been deteriorating and lagging behind the recoveries in other program countries, such as Portugal.[23] In fact, the improvements in the external deficit are mostly attributable to a substantial fall in imports.[24]

Among EU Member States, the percentage of high value added exports reaches 50%. Both Portugal and Greece's high value added exports are below this average (30% and 20% respectively in 2013).[25] However, Portugal has not displayed an increasing trend (the percentage of high value added exports is the same as in 1995), while Greece has (from 10% in 1995 to 20% in 2013).

When analyzing per product group, one may conclude that Greek exports depend to a lesser extent on manufactured goods and machinery and transport equipment. Both countries register noteworthy exports of petroleum products.

Although Portuguese exports still rely considerably on the textile and apparel industry, these sectors saw a shift from low quality and low price to high quality and high price. Another example of success is the shoe industry. As a solution for the increasing number of firms moving to countries with lower labor costs, this sector started to focus on the high-quality shoes segment.[26] In 2013, 94% of the production was exported.[27]

In order to keep their competitiveness in the global economy, developed economies must focus on more knowledge- and technology-intensive sectors.[28] During the 1995 – 2005 period, the technology content and diversification of exports comprehensively grew in these two countries. Although there were improvements, the low-technology and medium-low technology industries still represent an important share of exports.

Portugal and Greece should thus focus on industries with a higher technological content, since they normally entail the highest value added products and processes.[29]

22 Directorate-General for Economic and Financial Affairs, "The Puzzle of the Missing Greek Exports"– European Economy, 518, June 2014

23 Directorate-General for Economic and Financial Affairs, "The Puzzle of the Missing Greek Exports"– European Economy, 518, June 2014

24 Schöll (2013)

25 Prognos 2015

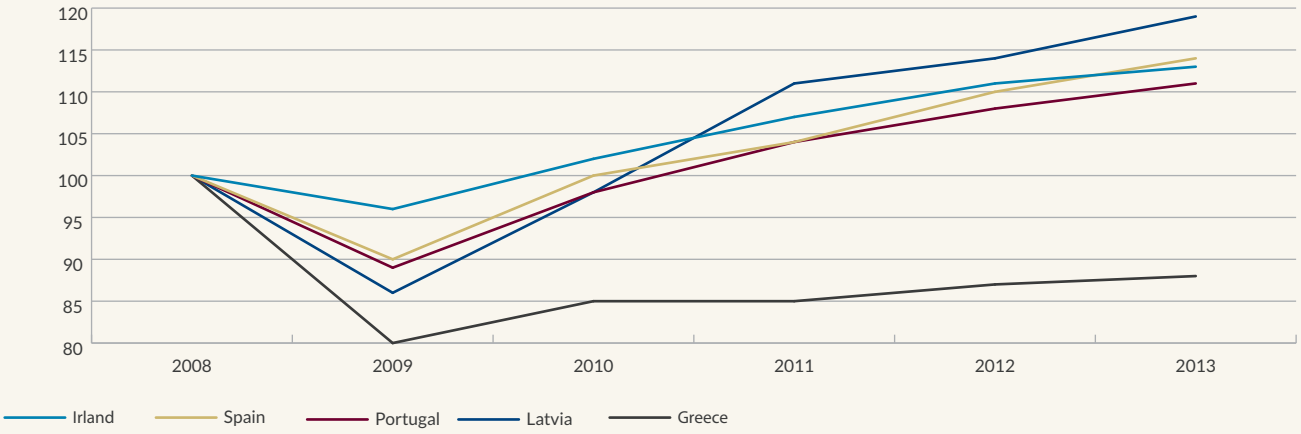
26 The Economist

27 APICCAPS

28 OCDE (2007)

29 Bennett et al. (2008)

FIGURE 12 **Real exports of Greece, Portugal and other program countries (2008=100)**



Source: European Commission

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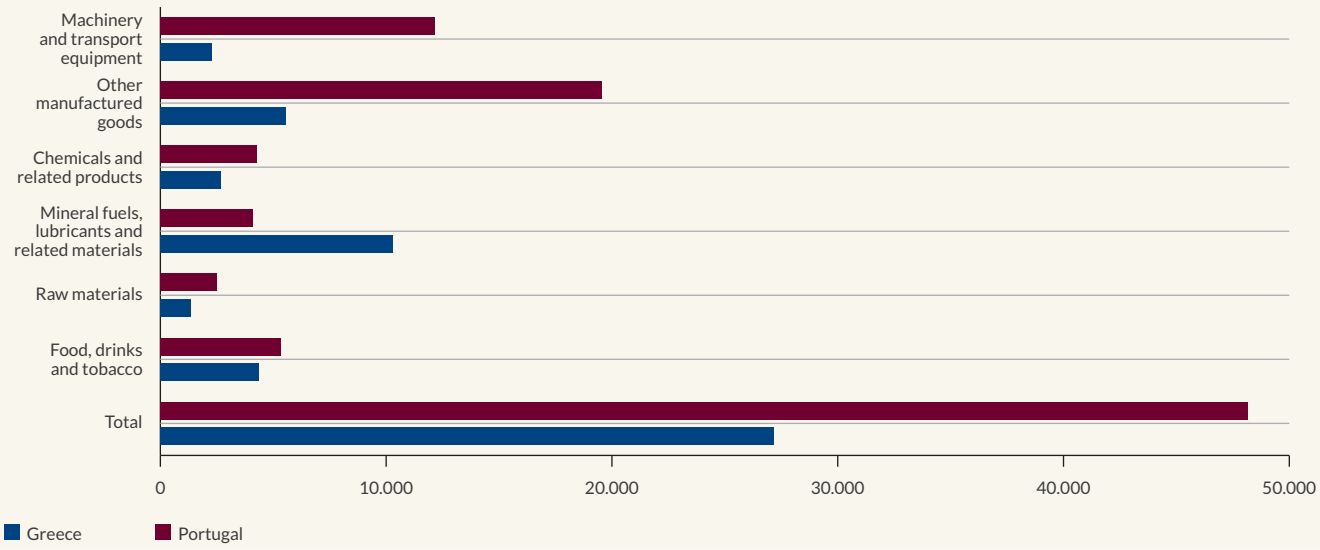
FIGURE 13 **Exports per product group (in millions of euros)**



Source: Eurostat, Accessed16-10-2015

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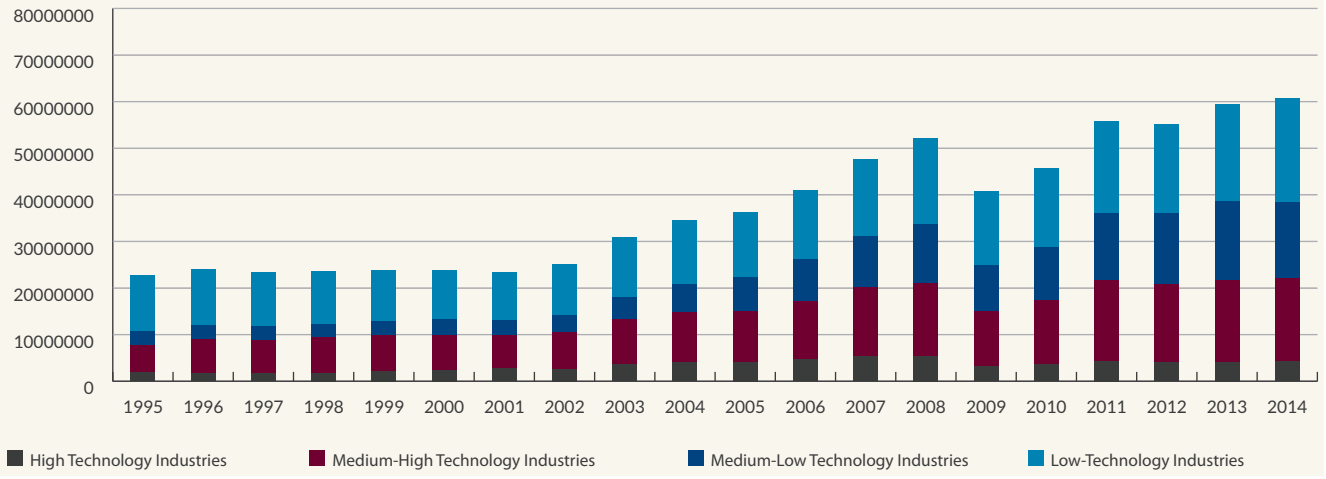
FIGURE 14 **Production technology intensity (thousands of $) – Portugal and Greece**



Source: OECD

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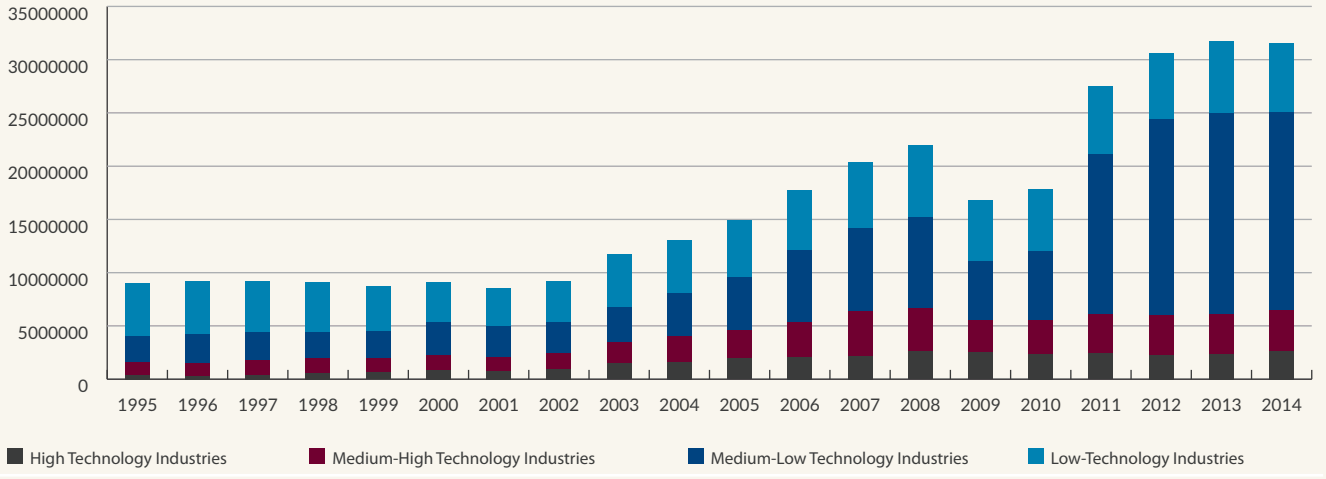
FIGURE 15 **Production technology intensity (thousands of $) – Greece**



Source: OECD

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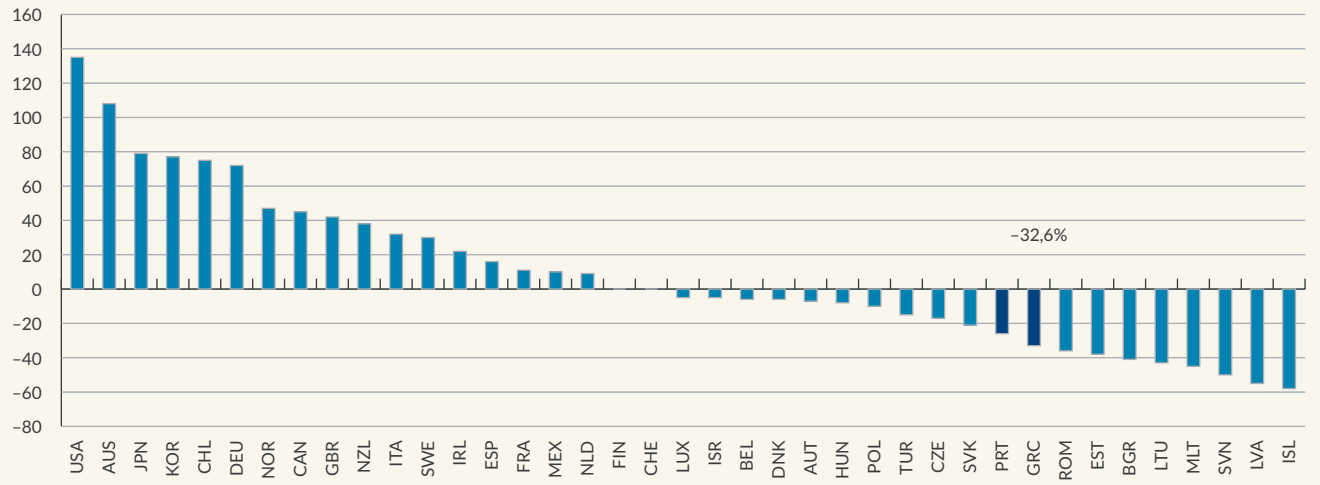
FIGURE 16 **Competitiveness ranking of countries based on the Gravity Model (%)**



Source: Directorate-General for Economic and Financial Affairs, "The Puzzle of the Missing Greek Exports," European Economy, 518, June 2014 | BertelsmannStiftung

Exports and competitiveness

The EC has computed a „Gravity Model" that allows it to rank a country's competitiveness in terms of exports (accounting for the country's size). Results show that Greek exports are 32.6% lower than predicted. This finding also holds for Portugal, which only ranks one position higher than Greece.

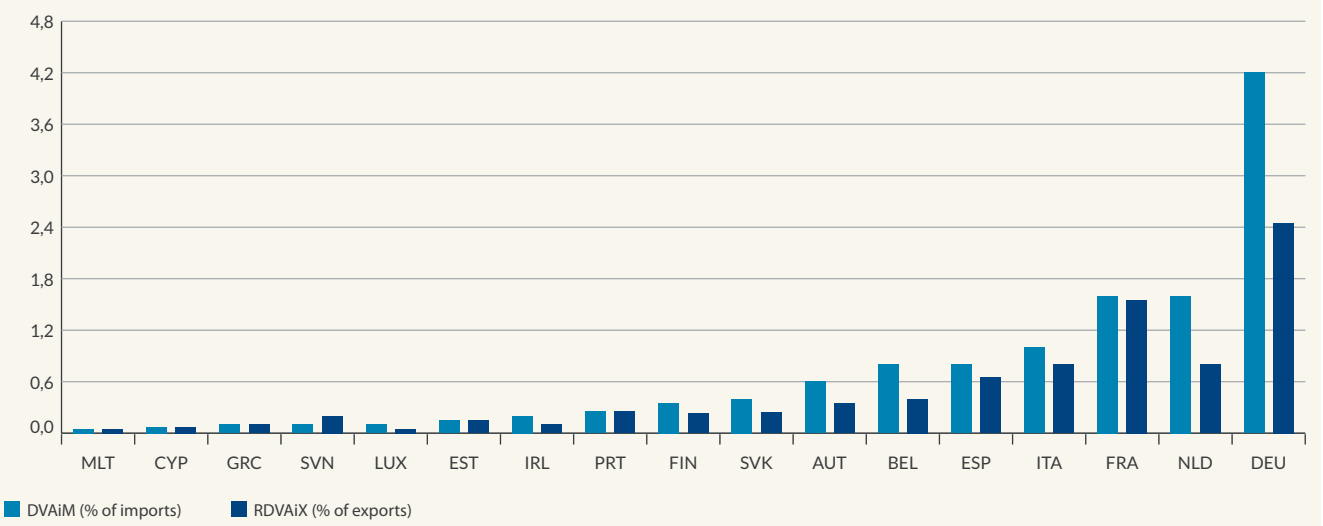
A strong export performance does not automatically impact growth. Traditional trade competitiveness measures, such as shares in world export markets, are being increasingly criticized given the increasing fragmentation of production chains. Thus, a country can gain export market share in a given product, but if the import content of such exports is increasing substantially, this makes a limited contribution to national GDP.

"The high import content of Portugal's exports is complicating the economy's external adjustment."[30]

The decrease in both transportation and communication costs leads to the fragmentation of production processes along Global Value Chains (GVC). Thus, it is important to understand the level of integration and the positioning of a country in the GVC. The level of integration can be measured through the level of import content on exports. The positioning is related to the re-export of domestic value added embodied in imports. Re-exporting value added normally means a higher participation in the initial and final stage of production, where the majority of the value added is created. The initial stages, where R&D and product concept and design are involved and the post-fabrication services (sales, marketing and after sales services) are expected to yield the largest value added.[31]

30 European Economic Forecast Autumn 2015
31 Amador (2014)

FIGURE 17 **Domestic value added in imports (DVAiM) and re-exported domestic value added in exports (RDVAiX) (%)**



Source: Amador (2014)

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The small values in both the domestic value added in imports and the re-exported domestic value added in exports confirm that both Greece and Portugal have a minor positioning in the initial and final stages of production chains, where most value added lies.

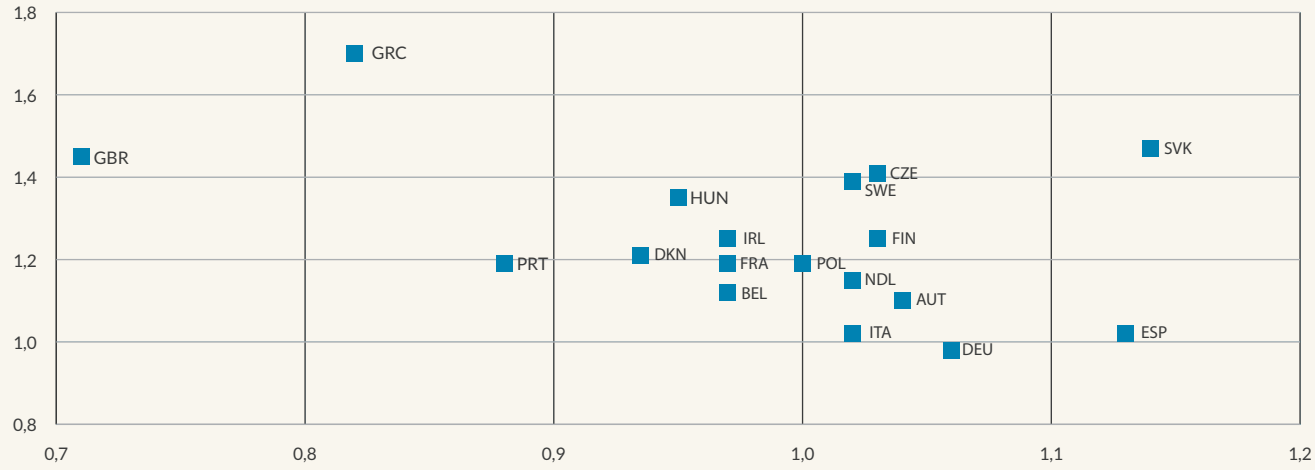
Portugal and Greece's geographic distance from core markets is seen as one of the limitations to participation in GVC.[32] This is a fact that can't be changed. However, other variables can be improved (this also holds for Greece). In order to move up in the value chain, several policy areas such as i) innovation policies; ii) policies to upgrade the human resource base of the economy; iii) policies to foster entrepreneurship and new areas of economic activity and iv) cluster policies and efforts at the local/regional level, need to be fostered.[33]

The international fragmentation of production chains affects both the distribution of incomes and jobs within countries. It is, therefore, important to shed light on the competitiveness of a country based on "value added and workers that are directly and indirectly related to the production of final manufacturing goods."[34]

Across all EU Member States, manufacturing GVCs providing jobs have been decreasing its importance, but this fall was particularly high in both Greece and Portugal (from 1995 to 2008 the percentage of manufacturing GVC workers as a share of all workers decreased by six percentage points and 7.2 percentage points, respectively).[35]

32 Amador (2014)
33 OECD (2007)s
34 Timmer (2012)
35 Timmer (2012)

FIGURE 18 **Change in employment versus change in real wage in manufacturing GVCs, 1995–2008 (1995=1)**



Source: Timmer (2012)

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Rapid wage rises in Greece and Portugal likely resulted in strong declines in manufacturing GVC employment.

When looking at the product categories in which these countries have revealed comparative advantages, one notices the food products and the non-durables categories. The food products sector is traditionally labor intensive.

FIGURE 19 **Revealed comparative advantage based on GVC incomes by product, major EU countries, 1995 and 2008**

Product	Year	Greece	Portugal
Chemicals	1995	0,87	0,81
	2008	0,99	0,76
Electrical Machinery	1995	0,31	0,5
	2008	0,41	0,64
Food Products	1995	1,82	1,04
	2008	1,62	1,06
Non-Electrictal Machinery and Metal	1995	0,21	0,53
	2008	0,63	0,72
Non-Durables	1995	1,82	2,69
	2008	1,47	2,22
Transport-Equipment	1995	0,3	0,54
	2008	0,4	0,71

Source: Timmer (2012); own graph

Tourism

In terms of services, both Portugal and Greece rely on tourism as a major backbone of their respective economies. In the Travel and Tourism Competitiveness Index 2015, Portugal ranked 15th and Greece ranked 31st (among 141 countries). Greece performs especially poorly in "business environment" and "price competitiveness" and Portugal in "air transport infrastructure" and "international openness."

Nevertheless, Greece registers a considerably higher share of European tourism revenue (3.8%) than Portugal (1.6%). Greece increased its international arrivals by 23% while Portugal's increased by 12% (from 2013 to 2014).[36]

36 World Tourism Organization UNWTO

Labor market

Given the important role of exports during recessions, it is imperative to analyze ways of improving the export performance of a given country. When a country has a fixed exchange rate (as Portugal and Greece do), one way to develop export performance is to improve its price competitiveness. Therefore, a country becomes more competitive if its export prices increase at a slower pace than those of its competitors.[37]

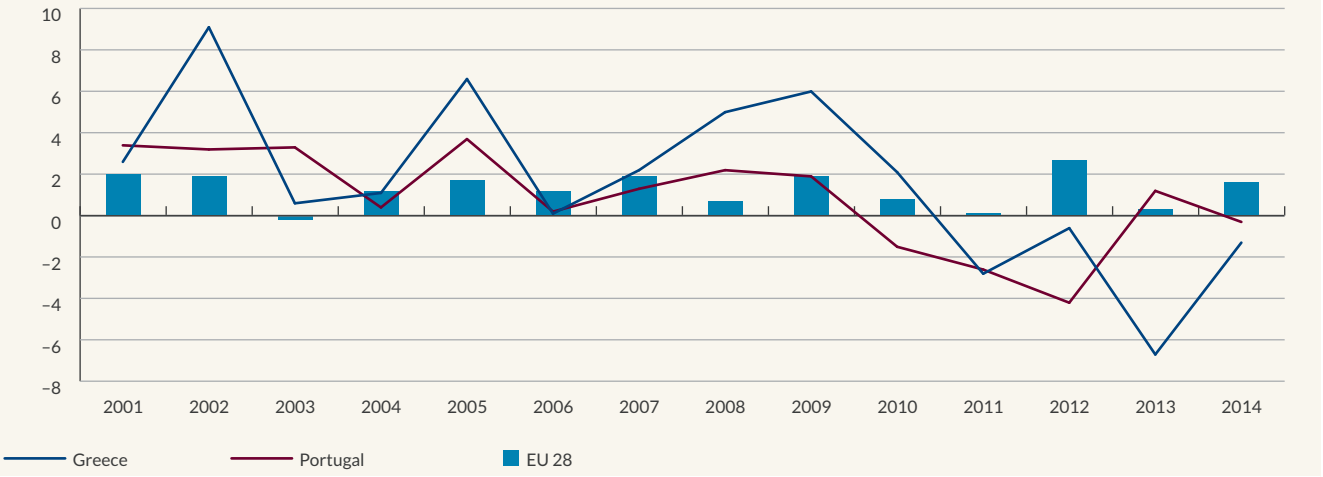
Labor costs had been increasing faster than productivity both in Greece and Portugal since the introduction of a common currency, which seriously undermined their external competitiveness. This trend has been reversed since the beginning of the sovereign crisis.[38]

In both Portugal and Greece the developments of unit labor costs damaged price competitiveness position prior to the beginning of the sovereign debt crisis. From 1995 to 2013, Greece ranked highest in nominal unit labor cost increases (2.8%), and Portugal ranked third (2.3%).[39]

In Greece, although some reforms in the labor market are already in place, the unemployment rate remains high (26.5% in 2014) in comparison to the EU average (10.2%) and to Portugal (14.1%).[40] In July 2015, the EC presented the Jobs and Growth Plan for Greece.[41] This €35 billion fund will mobilize resources for investment and cohesion crucial for re-establishing jobs and growth.[42] Pending actions regarding the labor market in Greece include the liberalization of restricted professions (notaries, actuaries and bailiffs). The government also agreed, by October 2015, to launch a consultation together with international institutions (e.g., International Labor Organization or ILO)

37 Prognos (2015)
38 OECD Employment Outlook 2014
39 Prognos (2015)
40 Eurostat
41 Jobs and Growth Plan for Greece
42 http://europa.eu/rapid/press-release_IP-15-5373_en.htm

FIGURE 20 **Unit labor costs (annual growth rate)**



Source: OECD, Accessed 16-10-2015

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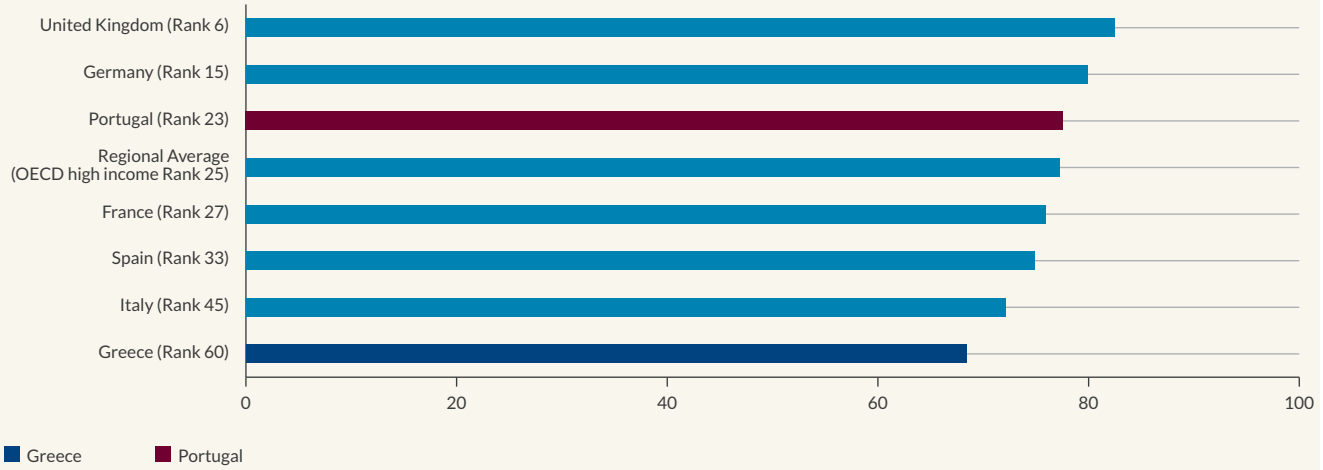
FIGURE 21 **World Bank Doing Business 2016**



Source: World Bank – Doing Business 2016

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Product markets and business environment

on collective dismissals, industrial action and collective bargaining.[43]

The labor market in Portugal has been characterized as the market of an OECD member with stricter employment protection, which has contributed to high segmentation. In 2012, Portugal introduced a labor reform bill which included: i) the reduction of severance payments; ii) the relaxation of the restriction on individual dismissals; iii) a cut in unemployment benefits and duration; iv) making working hours more flexible; v) facilitating collective agreements at company level; and vi) eliminating three working days of holidays per year, plus four days of statutory holidays. Nevertheless, and although labor market reforms take time to be perceived and traced, major changes are still needed, especially in the wage setting system.[44]

A decrease in unit labor costs will help both countries regain international competitiveness. However, since they could never win a wage race against Eastern European countries and other Asian countries, they need to focus on modernizing their production structures in order to specialize in high value added, capital-intensive sectors.[45]

The Doing Business Index calculated by the World Bank sheds light on ease of doing business in countries around the world. The distance to frontier score shows the distance needed to achieve best performance. For 2016, Portugal ranked 23rd (improved by two positions) while Greece only ranked 60th (improved by one position).

In Portugal, the Financial Assistance Programme contained reforms in the services sector, network industries and the judicial system. The administrative burden to start a new business fell considerably. However, further judicial reforms that shorten the length of legal proceedings are needed.

In order to foster its export potential, Greece needs to tackle the underlying institutional deficits, as it has already accomplished improvements in terms of cost competitiveness. According to the EC, "an improvement in the quality of Greek institutions up to the EU/OECD average would close the Greek competitiveness gap by between 54% and 78%, explaining large parts of the puzzle of the missing Greek exports."[46]

Greece has now adopted a new Code of Civil Procedure. Furthermore, it has agreed to propose measures to reduce the backlog of cases in administrative and civil courts by September and October 2015 respectively. A wide-ranging reform of the judicial system is currently underway in the context of the adjustment program, which has the potential to improve the performance of the system over time. The reform of the judicial system is of great importance, since the crisis resulted in an increase in trial length and a backlog of unresolved cases.[47]

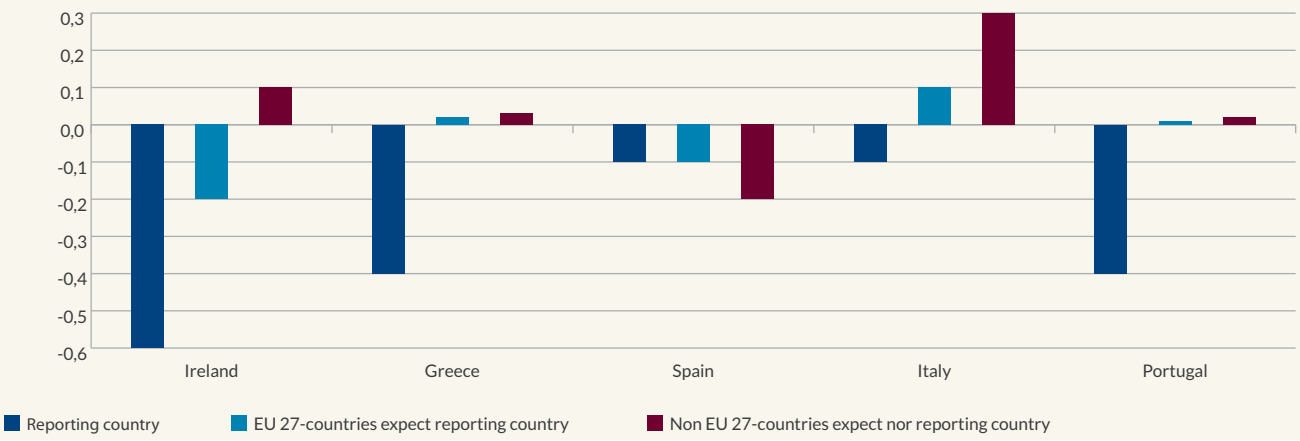
Nevertheless, both countries are still affected by bottlenecks in network industries, services, regulated professions and public administration.

43 Memorandum of Understanding
44 Portugal (2015)
45 Schrader

46 Directorate-General for Economic and Financial Affairs (June 2014)
47 http://ec.europa.eu/economy_finance/publications/european_economy/2014/pdf/ee5_en.pdf

Long-term challenges: Demographics

FIGURE 22 **Net migration (%)**



Source: Eurostat 2014

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The high unemployment rate in Southern Europe, especially youth unemployment, drove many citizens to emigrate. Although Spain and Italy did not register high absolute changes in net emigration, Portugal and Greece recorded a net emigration of around four individuals for every 1,000 nationals. The recent strong net emigration resulted in a 4% decrease of labor force in Portugal. Total population is estimated to have decreased by 1.5% between 2010 and 2014.[48]

Nevertheless, the limited mobility flows and high unemployment rates – which included highly educated workers in both these countries – mean that fears of a brain drain are currently not justified.[49]

Another warning sign is total fertility rate, which in Portugal in 2013 was the lowest among all EU Member States (1.21).[50] In Greece, it amounted to 1.30. Population aging together with negative migration flows pose serious challenges for national public pensions' systems.

48 http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp202_en.pdf

49 Barslund (2015)

50 Eurostat

Political developments

The implementation of the reforms agreed with the creditors diverged. In Greece there was less political support for the program than in Portugal.[51]

Evidence showed that both the Portuguese and the Greek governments acted opportunistically regarding expenditures in the presence of political cycles.[52] [53]

According to Afonso (2013), in Portugal, the implementation of austerity measures was agreed more easily than in Greece. One possible explanation is the lower levels of clientelism (the exchange of goods and services in return for political support) in Portuguese politics, compared to Greece. In Portugal, parties have lower membership rates and the main trade unions are tied to the Communist Party, which has never been in office. On the opposite side, trade unions in Greece are close to the two main ruling parties.[54] The clientelism theory might also explain the ascendance of "popular" parties in Greece (such as Syriza and Golden Dawn). By agreeing to implement austerity policies, the former main parties New Democracy and PASOK undermined their support basis (i.e., trade unions), which expected rents in exchange for political support.

The election of the left-wing party Syriza culminated in the signing of the third Memorandum of Understanding, as creditors and the government failed to reach an agreement regarding the second Financial Assistance Programme.

After the inconclusive results that stemmed from the general elections on 4 October, Portugal faced political instability. The Forward Portugal alliance (PàF) – the parties of the incumbent government – won with 38.6%. However, since the alliance did not reach an outright majority in parliament, the socialists (who got 32.3% of the votes) together with the Left Bloc party and the Communist Party have a majority in terms of seats in parliament. Thus, the leader of the Socialist Party, António Costa, has called on President Cavaco Silva to appoint him as prime minister. The appointment of a center-left coalition (incorporating the Socialists, Left Bloc and the Communist Party) would mean an end to austerity measures, since these parties have agreed to reverse cuts to public sector pay and to unfreeze state pensions.

On 23 October, President Cavaco Silva decided to ask PàF to form a government. He claimed in a public speech that he could not appoint a center-left coalition which included parties (Left Bloc and the Communist Party) that oppose Portugal's membership to international institutions such as the EU and NATO. But the new government's program was not approved in the parliament by the center-left parties. Thus he appointed the leader of the Socialist Party, António Costa, as the prime minister. He has stated this government will comply with the eurozone fiscal rules.

51 Pisany (2013)
52 Castro (2015)
53 Skouras (2011)
54 Afonso (2015)

Main conclusions

Both countries suffered from macroeconomic misalignments: persistent large external deficits and budget deficits, or the "twin deficits." The minor risk premiums in the eurozone has allowed Portugal and Greece to accumulate large imbalances since joining the common currency. The 2008 financial crisis undermined the capacity for Portugal and Greece to obtain financing in the markets thanks to the loss of confidence by investors.

The Financial Assistance Programmes were based on overly optimistic assumptions regarding GDP growth and unemployment. Although the worse-than-expected macroeconomic environment played a part in this, the talks about a possible Grexit and the lack of political stability also contributed for a worsened scenario.

The implementation of the reforms agreed with the creditors diverged. In Greece there was less political support for the program than in Portugal, and thus the implementation of the reforms was often not successful.

Several problems hamper(ed) these economies' competitiveness: unit labor costs increase at a faster pace than productivity, and there are rigid labor and product markets. Structural reforms are thus needed. Belonging to a currency union means losing control over monetary policy, so it is not possible to depreciate currency in order to increase external competitiveness. Internal wages and price depreciation is therefore the way to increase competitiveness and hence exports. Indeed, over-reliance on domestic demand as a GDP growth booster was one of the problems that both countries suffered.

This over-reliance on domestic demand seemed to be one of Greece and Portugal's structural problems. A turnaround in the export sector could thus help to offset the negative consequences of austerity policies, which require governments to cut spending. In Portugal the recession was less acute than in Greece since the fall in domestic demand was offset by an increase in net exports. The worse-than-expected recession in Greece can be attributed, to some extent, to the lack of export recovery (although a fall in imports helped to balance the external account).

The concentration in low- and medium-low-technology industries in exports doesn't allow these countries to produce high value added to products. Furthermore, integration in GVCs remains limited. The positioning in the GVCs shows the need to change to the up- and downstream, where the majority of value added is created.

In order to foster exports Greece has to improve the quality of its institutions. Further labor market reforms are still needed in order to regain external competitiveness. Bottlenecks in network industries, services, regulated professions and public administration need to be tackled.

The labor market reforms already in place might suffer from a time lag until they produce objective effects, given the time required by labor and product market reforms to produce observable results.

Challenges ahead

- External climate: quantitative easing and disinflationary trends in the eurozone might hinder debt payments; an increase in oil prices.
- The ongoing deleveraging process in the corporate sector will hold back investment.
- Thus, corporate investment in GFCF must be incentivized in order to prevent further long-lasting damaging effects to the economy's dynamism.
- Completion of the Banking Union, in order to end banking fragmentation and promote investment.
- The public pension system needs urgent reforms. In the long run, economic growth may be constrained due to a reduction in total population (due to migration flows), together with population aging due to the lowest fertility rate in the EU.
- Challenges ahead for Portugal: political instability, which may last until new elections take place

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