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Thinking ahead for Europe

Greece and Portugal
Similar fundamentals but different outcomes?

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The leaders of the eurozone are increasingly playing hardball with Greece as the repeated failure of the country to implement promises and plans has made the 'moral hazard' risk of bail-outs only too apparent. But while the ultimate outcome in Greece continues to be balanced on a knife edge, the fate of Portugal has become crucial for the future of the eurozone because the official line is that Greece is a 'unique and exceptional' case.

In the case of Greece, all the attention has been focused the level of public debt and the ongoing deficit. On this score, Portugal does much better as its debt level is at a level that Greece might not achieve in 10 years – even *after* a hefty cut on the debt held by (foreign) banks. This is also the reason why Portugal has been privately assured of further support by Germany. But policy-makers must recognise that excess private consumption is the real problem in Portugal. And if this problem is not addressed, they eurozone might soon have another country which will need debt forgiveness.

Portugal's policy-makers are understandably confused by the reaction of the markets to their heroic efforts to cut the budget deficit in the face of a rapidly contracting economy. The risk premium on Portuguese government bonds has rise to double-digit levels while it has fallen for everybody else, except Greece.

But the problem of Portugal is not fiscal policy. It is the excess consumption of the private sector which for more than ten years now has become used to spending much more than its income. This can be seen in the large current account deficits the country has run (over 10% of GDP for more than ten years), whose cumulative effect is now a net foreign debt worth more than 100% of GDP, slightly more than even that of Greece.

In Greece the excess consumption was financed by the government and as a consequence most of the foreign debt was owed by the government. A fiscal adjustment coupled with a cut to the government debt thus addressed the core of the problem for Greece. Not so for Portugal. In this country, the excess spending was not financed by the government, but by banks (and partly at least by branches and subsidiaries of Spanish banks in Portugal).

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This is also the reason why, despite the strong fiscal adjustment, the external current account of Portugal is still in a large deficit. The deficit is now declining, but even the government does not predict an external surplus as far as the eye can see. The two countries which so far have weathered the crisis best, Ireland and Latvia, both achieved a current account surplus within less than two years.

At first sight, one is tempted to say: so what? Why should the markets worry if Portuguese households continue to consume and Portuguese enterprises invest on credit. As long as the government gets its accounts under control, the risk premium on government debt should decline. However, markets factor in a simple lesson learnt from this crisis: excess private debt becomes in the end public debt. The losses that Portuguese banks are likely to experience when their customers (both households and firms) cannot service their debt as the economy spirals downwards will in all likelihood become public debt – just as happened in Ireland and Spain. What matters in the end is the total debt (public plus private) of the country. This presents the authorities in Lisbon with a particular challenge: they must not only get their fiscal accounts under control, but they must also rein in their own banking system to ensure that spending falls to a level that is compatible with income. This would require another fall in (private) consumption of over 10% and a similar fall in construction investment. Both would be highly unpopular. But if this is not done, the country's adjustment efforts cannot succeed.

The official mantra is that structural reforms will lift the growth rate. The increase in productive capacity will then avoid the need for spending cuts. But this strategy rests on two assumptions that have rather weak empirical foundations. First of all, the record of structural reforms to lift growth even in the medium term (say over 5 years) is very patchy. The most that can realistically be expected on this front are fractions of a percent of GDP. Secondly, a higher growth rate often also leads to higher wages and higher spending. Thus a higher growth rate per se is unlikely to cure an entrenched current account deficit.