

INTERNAL DEVALUATION AND UNEMPLOYMENT: THE CASE OF PORTUGAL

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SUMMARY

The financial crisis of 2008 led European Union (EU) member states to adopt interventionist measures in order to rescue the financial system. This was done through the injection of public funds, with negative impact on national public deficits. The impact was more substantial on smaller economies and those that were more vulnerable to external shocks, such as the Portuguese economy.

The external shocks suffered by the Portuguese economy in the 2000s and the crisis of 2008 helped bring Portugal's structural problems to the fore. This provided the ideal conditions for working out an adjustment programme (MoU), based on restrictive budgetary and financial measures which was expected to lead to the consolidation of public finances, to economic recovery and to job creation.

The rationale underlying the macroeconomic adjustment programme is that Portugal has suffered a major loss of competitiveness over the past decade, purportedly due to the higher increase in unit labour costs there than in its euro area partners. In order to restore national competitiveness, and taking into account that adjustment of the nominal exchange rate is not an option for the euro area member states, the macroeconomic adjustment programme rested on an internal devaluation strategy focusing on the downward adjustment of unit labour costs and/or prices.

This strategy of internal devaluation was implemented together with a reform of the labour market aiming at increasing its flexibility and, thus, fostering job creation. However, the assessment of the macroeconomic adjustment programme in terms of employment is disappointing. The unemployment rate reached 17.5 per cent in the first quarter of 2013, while the macroeconomic adjustment programme signed in 2011 forecasted a peak of unemployment at 12.4 per cent in 2012.

In addition to the increase in the number of unemployed people, there was in the last four years a profound change in the Portuguese labour market, with a reduction of the Portuguese workforce and of the number of employed people, an increase in the number of people who left the labour market (especially people who had stopped looking for jobs and emigrants), as well as a reduction in the wage level (in both the public and the private sector).

The assumption that wage reductions will increase the competitiveness of the Portuguese economy is at least questionable. It should be noted that company wage costs in Portugal (including salaries and social security charges) represent only 21 per cent of their production costs. In fact, the internal devaluation process had a huge impact on the decrease in household income, with a negative impact on domestic demand and imports, but little impact on the external competitiveness of Portuguese economy (export growth rates between 2012 and 2014 were lower than before the MoU).

The structural weaknesses of the Portuguese economy lie in the low level of formal education compared with other advanced economies, profile specialisation and exports based on low and medium-low technology intensity sectors. These factors led to low levels of R&D and a low innovative capacity in enterprises, reflected in low productivity. Thus, Portugal found it difficult to compete with economies with lower wages and higher levels of qualifications, at the same time as it became more difficult to compete with more advanced economies, given the low skill level of the Portuguese population and business innovation.

However, in the last four years, **there has been no change in the economy's specialisation profile, the technology intensity of exports or labour productivity.** Furthermore, Portugal's innovative capacity has decreased to the levels of 2007.

Portugal needs a new medium-term strategy focused on public policies that support innovation, workforce qualification, the promotion of knowledge and changes in the specialisation profile of the economy towards higher added value activities. In brief, a new generation of public policies is needed in order to promote sustainable growth, consolidate public finances and create more and better jobs.

TABLE OF CONTENTS

INTRODUCTION	3
1. The Portuguese labour market: main problems and recent reforms	4
1.1. The Portuguese economy and its labour market before the euro area debt crisis	4
1.1.1. Economic outlook	4
1.1.2. Evolution of the Portuguese labour market	7
1.2. Labour market reform, 2011–2014	10
1.2.1. Employment protection	10
1.2.2. Unemployment benefits	11
1.2.3. Working time arrangements	11
1.2.4. Collective bargaining	11
1.2.5. Active labour market policies	11
1.3. Reducing unit labour costs... while cutting public spending	12
2. Assessing internal devaluation in Portugal	13
2.1. Was the strategy successful in improving competitiveness and boosting potential growth?	13
2.2. Was the strategy successful in fostering job creation?	16
3. Strengthening competitiveness and reducing unemployment in Portugal – defining a new strategy	22
3.1. Calling into question the principle of internal devaluation	22
3.2. Looking forward: which way for more and better jobs in Portugal?	25
4. Final remarks	26
ON THE SAME THEMES...	30

INTRODUCTION

In 2000, Portugal had among the lowest unemployment rates in the European Union, at 3.9 per cent (as against 7.8 per cent on average in the EU15). Eight years later, unemployment had almost doubled, rising to almost 11 per cent in 2010 due to the impact of the global financial crisis.¹

“IN 2000, PORTUGAL HAD AMONG THE LOWEST UNEMPLOYMENT RATES IN THE EUROPEAN UNION”

Several factors have contributed to this strong increase in unemployment in Portugal over the past decade. In the macroeconomic adjustment programme that Portugal signed with the EU and the International Monetary Fund (IMF) in 2011,² two main reasons were put forward to explain it. First, unit labour costs increased more in Portugal than in its main trading partners since the introduction of the euro, which caused a major loss of competitiveness and thus hampered job creation. Second, the rigidity and inefficiency of the labour market; according to the Organisation for Economic Cooperation and Development (OECD), Portugal has the highest level of employment protection among its members. Although the assessment contained in the Memorandum of Understanding (MoU) also mentioned other factors, such as the low education level of the population and other macroeconomic features – such as a loss in market share for labour-intensive goods due to the strengthening of Asian and eastern European competition – the priority of the macroeconomic adjustment programme was to address the two first factors mentioned above.

To this end, a strategy of internal devaluation was implemented to reduce unit labour costs and restore competitiveness, together with a reform of the labour market to increase its flexibility. These measures, together with other structural reforms – of product markets, competition rules and the judicial system, among others – were expected to boost growth, create jobs and improve competitiveness. However, at the end of the implementation of the MoU, the assessment of the macroeconomic adjustment programme in terms of unemployment was disappointing. The unemployment rate reached 17.5 per cent in the first quarter of 2013, although while the macroeconomic adjustment programme signed in 2011 forecasted a peak of unemployment at 12.4 per cent in 2012. Portugal today has the fifth highest unemployment rate in the EU, after Greece, Spain, Cyprus and Croatia.

Despite this negative trend, some will argue that the adjustment of the Portuguese economy is on track and starting to bear fruit: rising unemployment was reversed in mid-2013 and in 2013 Portugal recorded its first current account surplus for twenty years. Others will claim that these positive trends do not stand up to scrutiny and persist in their negative assessment of the impact of the MoU on the Portuguese economy.

The aim of this paper is to shed light on (i) the determinants of the unemployment trend in Portugal, (ii) the impact of the internal devaluation strategy pursued since the adoption of the MoU in 2011 and (iii) the priorities that should be on the top of the national reform agenda to foster job creation in Portugal. The paper is structured in three sections. Section 1 presents a critical overview of the situation in the Portuguese labour market included in the Macroeconomic Adjustment Programme for Portugal, as well as a summary of the main reforms. Section 2 assesses the internal devaluation strategy implemented between 2011 and 2014, which aimed at restoring competitiveness and fostering job creation. Finally, Section 3 calls into question the need for an internal devaluation strategy in Portugal and presents some priorities for a new strategy to ensure more and better jobs in Portugal.

1. This paper, completed in May 2015, will also appear as a chapter in the forthcoming book 'Unemployment, Internal devaluation and Labour Market deregulation in Europe', edited by Myant Martin, Theodoropoulou Sotiria and Agnieszka Piasna. The book is expected in early 2016 and the research for it was supported by the ETUI.

2. See: Directorate-General for Economic and Financial Affairs (2011) The Economic Adjustment Programme for Portugal, Occasional papers 79, June 2011, European Commission.

1. The Portuguese labour market: main problems and recent reforms

“THE LABOUR MARKET WAS CONSIDERED HIGHLY INEFFICIENT”

In the context of the negative developments in the euro area bond markets which started at the end of 2009 and taking into account the political crisis in Portugal in spring 2011, in 2011 the country was unable to refinance in the financial markets and had to request a financial assistance programme from the EU and the IMF. In exchange for a loan of 78 billion euros, the country committed itself to a macroeconomic adjustment programme, which foresaw comprehensive action on three fronts: fiscal consolidation, safeguarding the financial sector and structural reforms to boost potential growth, create jobs and improve competitiveness. The adjustment programme was expected to act as a catalyst for structural reforms and one of the main reform objectives was to improve labour market performance. Indeed, the labour market was considered highly inefficient due to the strictness of employment protection, the generosity of unemployment benefits, the rigidity of working-time arrangements and the centralised wage bargaining system that was unable to keep wage growth in line with productivity developments. This inefficient labour market was identified by the IMF and the European Commission (EC) reports as one of the main causes of the country’s major loss of competitiveness during the past decade, which has undermined Portugal’s economic performance since the introduction of the single currency.

We start this paper with a short presentation of the Portuguese economic outlook before the global financial crisis of 2008, as well as of the main problems of the Portuguese labour market identified in the macroeconomic adjustment programme (Section 1.1). We then provide a short overview of both the reform of the labour market that has been implemented since 2011 (Section 1.2) and the measures adopted to achieve an immediate reduction in unit labour costs, while at the same time cutting public spending (Section 1.3).

1.1. The Portuguese economy and its labour market before the euro area debt crisis

The deterioration in unit labour costs after 2000 is identified in the Macroeconomic Adjustment Programme as one of the causes of the major loss of competitiveness of the Portuguese economy and of the increase in the unemployment rate during the past decade. However, to understand the problems of the Portuguese labour market before the euro area debt crisis, it is necessary to analyze the evolution of the Portuguese economy in the 1990s and 2000s.

1.1.1. Economic outlook

After Portugal’s integration in the European Union/European Economic Community (EU/EEC), we can identify two economic cycles of the Portuguese economy (Banco de Portugal 2009): a more intensive growth and catching-up period (1986–1997) and a less intensive growth and divergence period (1998–2008). During the first period, Portuguese GDP grew 4.1 per cent annually in real terms (almost twice as high as the euro area average), mainly pushed by private consumption (5.3 per cent), investment (6.5 per cent) and exports (7.6 per cent), with all GDP components on higher growth rates than those registered in the euro area (Table 1). By contrast, in the period 1998–2008 the annual growth rates of all GDP components and GDP itself were lower (less than half) than in the previous period. Real GDP grew below the euro area average, meaning that a trend change in the Portuguese convergence process occurred in 1986–1997.³

3. This convergence can also be seen in terms of GDP per capita: between 1985 and 2000 Portugal’s GDP per capita relative to the EU15 increased from 59.6 per cent to 74.5 per cent (EU15=100, 1995 PPS). Source: AMECO.

Table 1 ► GDP indicators 1986–2008 (average annual rate of change, %)

	PORTUGAL		EURO AREA	
	1986-1997	1998-2008	1986-1997	1998-2008
GDP growth rate	4.1	1.8	2.4	2.1
Private consumption	5.3	2.4	2.4	1.9
Public consumption	4.5	2.3	1.9	1.9
GFCF - Investment	6.5	1.0	2.9	3.1
Exports	7.6	4.4	5.9	5.7
Imports	12.2	4.6	6.1	5.8
Potential product growth rate	3.7	1.1	2.4	1.9
Employment	0.7	0.4	0.4	0.9
Capital stock	1.2	0.9	0.8	0.8
Total Factor Productivity	1.8	0.3	1.2	0.3

Source: Adapted from Almeida et al. (2009). Data from Bank of Portugal and AMECO. Variables in real terms.

The reasons for the decline in growth are both internal – structural problems of the Portuguese economy – and external, such as financial and monetary integration (late 1990s) and changes in world trade (in the 2000s), leading to a loss of external competitiveness.

The impact of the financial and monetary integration in the 1990s eliminated the exchange rate risk premium, due to the escudo's integration in the exchange rate mechanism of the European monetary system from 1992 and the subsequent maintenance of a relatively stable exchange rate until the accession of Portugal to the euro in 1999. This process facilitated the access of financial institutions to international funding markets (due to the lower costs of capital), resulting in a sharp drop in interest rates (real interest rates declined from 6 per cent in 1992 to roughly 0 per cent in 2001; see Blanchard 2006: 4), which fed a strong increase in domestic demand – increased demand for intermediate goods and final consumption – which raise the level of Portugal's external indebtedness (Antão *et al.* 2009). In Table 1 we can see that consumption growth (both private and public) was higher in Portugal than in the euro area as a whole (in both periods) and that imports grew 12.2 per cent annually in the period 1986-1997 (6.1 per cent in the euro area). In both periods, import growth rates were higher than export rates, which put pressure on the current account balance, namely in goods (Tables 1 and 2).

Another external shock that the Portuguese economy suffered involved changes in global competition, related to China's accession to the World Trade Organization (WTO) in 2001 and EU enlargement to central and eastern European countries in 2004. These two factors exposed the Portuguese economy to more competitive countries, with lower production costs and wages – both China and central and eastern Europe – and with higher skills (mainly central and eastern Europe; Reis *et al.* 2013), which affected some Portuguese labour-intensive sectors, such as textiles and footwear.

The exposure to more competitive – based in low-cost production – economies highlighted the structural weaknesses of the Portuguese economy, namely the low level of formal education compared with other advanced economies, profile specialisation and exports based on low and medium-low technology intensity sectors, with most jobs concentrated in these areas (see Section 3.1 for further details). These factors led to low levels of R&D and a low innovative capacity in enterprises, reflected in low productivity (Almeida *et al.*, 2009). In fact, in the period 1998-2008 the potential product growth rate was three times lower than in the period 1986-1997, mainly due to a six times lower growth rate of total factor productivity (Table 1), but also to a lower contribution from employment and capital stock. Thus, Portugal found it difficult to compete with economies with lower

wages and higher levels of qualifications, at the same time as it became more difficult to compete with more advanced economies, given the low skill level of the Portuguese population and business innovation.

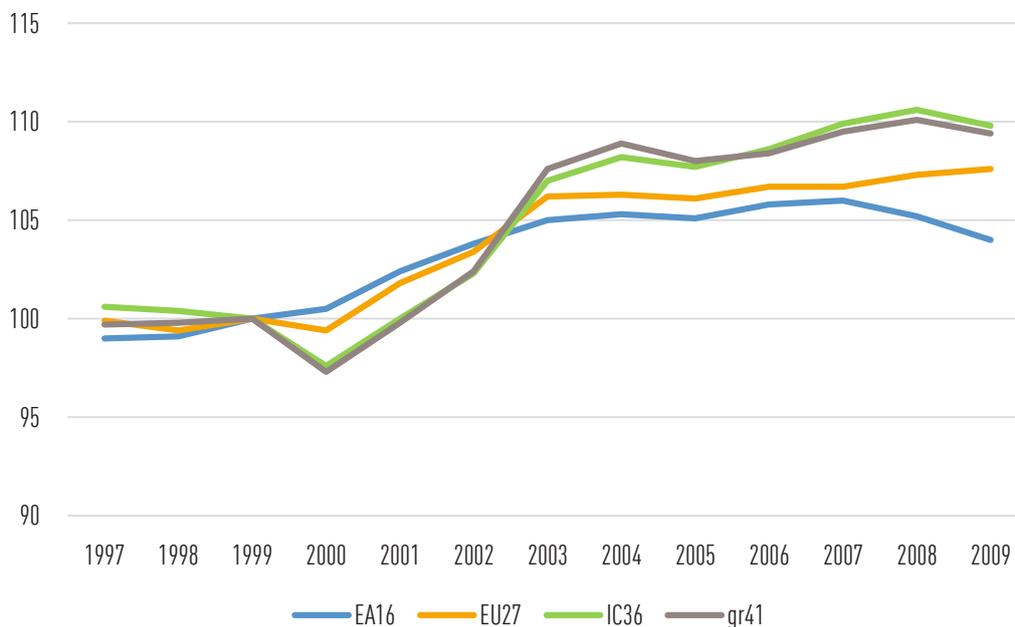
Table 2 ► Main economic indicators, Portugal, 1995–2010

	1996	1997	1998	1999	2000	2002	2004	2006	2008	2010
Real GDP growth rate	3.7	4.4	5.1	4.1	3.9	0.8	1.6	1.4	0	1.9
Inflation rate	–	1.9	2.2	2.2	2.8	3.7	2.5	3	2.7	1.4
Unemployment rate	7.2	6.7	4.9	4.4	3.9	5.0	6.6	7.6	7.6	10.8
Labour productivity growth (annual % change)	1.9	1.7	1.6	2.9	1.3	0.7	1.3	1.4	0.2	3.7
Gross household savings (% of GDP)	8.4	7.8	8.6	8.1	7.4	7.7	7.1	5.6	4.8	6.6
Public debt (% of GDP)	59.5	55.2	51.8	51.0	50.3	56.2	62.0	69.2	71.7	96.2
Public deficit (% of GDP)	-4.7	-3.7	-4.4	-3.0	-3.2	-3.3	-6.2	-4.3	-3.8	-11.2
Current account balance (% of GDP)	-4.5	-6.2	-7.5	-8.9	-10.8	-8.5	-8.3	-10.7	-12.1	-10.1
Goods (% of GDP)	-8.7	-9.8	-11.3	-12.3	-13.3	-11.0	-11.2	-11.6	-13.4	-10.7
Services (% of GDP)	1.7	1.8	2.2	2.1	2.5	2.8	3.1	3.4	4.0	3.6
Capital Balance (% of GDP)	2.0	2.5	2.1	2.1	1.4	1.9	1.7	1.2	1.2	1.4

Source: Eurostat and PORDATA/INE.

We must also mention the importance of the increase in inflation from the end of the 1990s (Table 2), rising to around 3 per cent (2.8, 3.7 and 3 per cent in 2000, 2002 and 2006, respectively) in the 2000s and thus causing a deterioration in the real effective exchange rate (REER) compared with other economic areas. In Figure 1 we can see the deterioration of Portuguese competitiveness in the 2000s (an increase in the REER index) relative to the euro area countries, the EU27, a group of 36 industrialised countries and a broad group of 41 other countries. This trend, coupled with low levels of productivity in the 2000s (Table 1), contributed to the decline of Portuguese exports and an increase in the annual deficit of the current account balance, from -4.5 per cent in 1996 to -12.1 per cent in 2008 (Table 2). The Portuguese case is the opposite of that recorded in other countries – such as Ireland – where real exchange rate appreciation (caused by an increase in inflation) coexisted with high levels of productivity, resulting in high exports (OECD 2007. See Figure 1).

Figure 1 ▶ Real effective exchange rate, based on harmonised index of consumer prices (HICP) / consumer price index (CPI), Portugal vs economic areas (annual data, index 1999=100)



Source: European Commission (2010b)

In short, internal and external factors led to an increase in domestic demand (private and public consumption) that was higher than real GDP growth, a higher growth rate of imports relative to exports (Table 1) and a decline of export growth rates, related to the appreciation of the REER (Figure 1) and to low levels of productivity (which influenced the evolution of nominal unit labour costs). All this contributed to unbalanced growth associated with a falling savings rate and to deficits in the current balance and the capital balance (Table 2). The changes in global trade led to a reorientation of foreign direct investment from Portugal to central and eastern Europe and to China (due to their lower production costs and higher skills), making Portugal less and less attractive for productive investment (in the period 1998–2008, the GFCF growth rate was six times less than in the period 1986–1997, see Table 1), attracting primarily financial capital, in the form of credit, due to the growth in domestic demand (Reis *et al.* 2013). This led to a deterioration of the capital balance in the 2000s (Table 2). Another factor was pressure on the labour market due to the growing competition from China and central and eastern Europe in the sectors more exposed to international competition – low-skilled jobs sectors – which helped to push the unemployment rate in the 2000s (Table 2).

1.1.2. Evolution of the Portuguese labour market

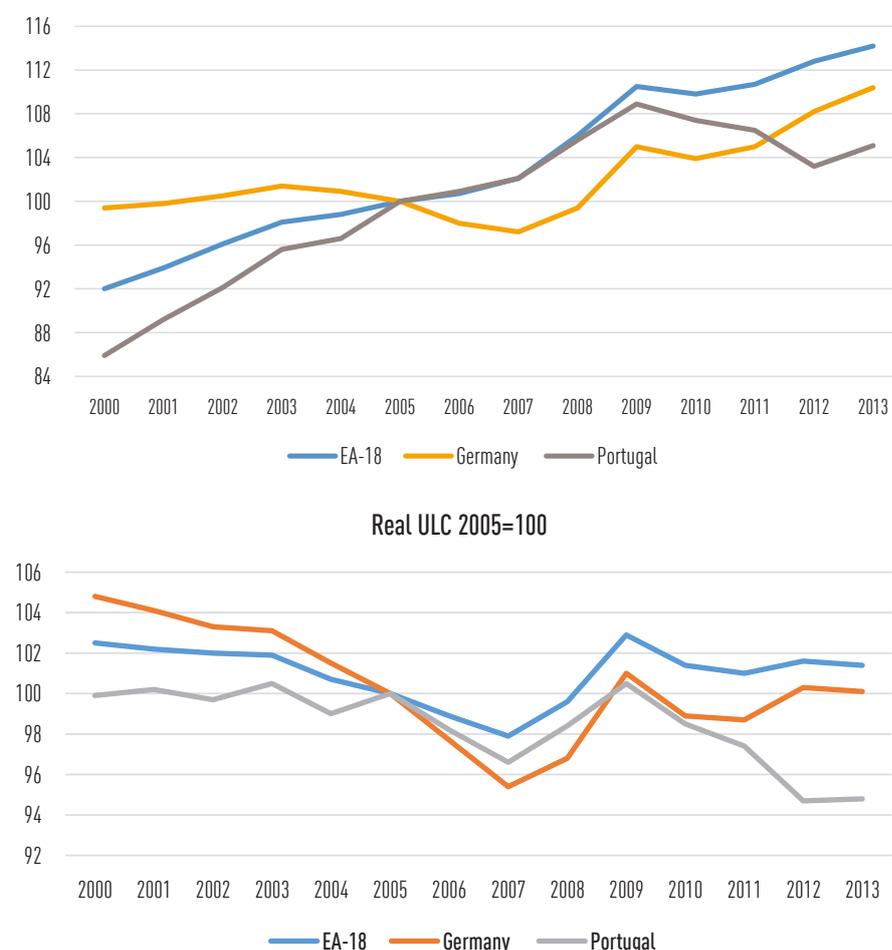
The two economic cycles of the Portuguese economy had an impact on the labour market and on the unemployment trend. The high GDP growth in the 1990s led to a steady decrease in unemployment, from 7.2 per cent in 1996 to 3.9 per cent in 2000 (Table 2). In 2000, Portugal recorded one of the lowest unemployment rates in the EU, at 3.9 per cent against 7.9 per cent in Germany and an average 7.8 per cent in the EU15. With low unemployment rates until the early 2000s (despite the rigidity of the Portuguese labour market, according to international reports), nominal wage growth was substantially higher than labour productivity growth, leading to a growth in nominal unit labour costs. Due to the downward rigidity of nominal wages and a high inflation rate, in the period 2000–2009 wage growth continued to outstrip productivity growth even though the country recorded low GDP growth and unemployment started to rise, from 3.9 per cent in 2000 to 7.6 per cent in 2008 (Table 2). As a consequence, in the period 2000–2009 there was a significant increase in nominal unit labour costs in Portugal, as in the EU18. Figure 2 illustrates that, even though nominal unit labour costs increased in Portugal in the 2000s, they remained below or at the same level as average nominal unit labour costs in the euro area (EA18). Nominal unit labour costs increased at a higher rate than in the EU18 until 2005 and at a similar rate between 2005 and 2009.

In a context of exposure to more competitive economies, based in lower production costs and higher labour skills - for example, China and central and eastern Europe - the increase in unit labour costs helped to render the Portuguese economy less competitive in goods manufacturing and in services, as well as to reduce enterprise competitiveness and increase unemployment. This loss of competitiveness - increase in unit labour costs - was common to countries such as Spain, Greece, Italy, France and Ireland in the period 2000-2009, and in Germany from 2007 (Figure 2). Nevertheless, as outlined by Almeida and Caldas (2014), if we consider a longer period in the analysis of unit labour costs growth in Portugal (not only the past decade), we can conclude that between 1996 and 2007 wages (in real terms) grew by 11 per cent and productivity by 15 per cent; in other words, wages in Portugal developed below productivity during the period in question. Also Ordóñez et al. (2014: 1) conclude that the development of real unit labour costs in Portugal is not the main cause of its loss of competitiveness, from a long-term perspective:

Portugal, Ireland, Italy, Greece and Spain succeeded in reducing their real unit labour costs by more than their northern partners. With the exception of Ireland, however, technological progress was weak; it was through capital intensification that periphery economies gained efficiency and competitiveness... We conclude by outlining technology as the key convergence factor.

Finally, Figure 2 also illustrates that the adjustment of nominal unit labour costs in Portugal started in 2010, before the macroeconomic adjustment programme was entered into with the Troika. Indeed, after 2009, nominal unit labour costs have decreased in Portugal, contrary to what happened in the EU18. This is also reflected in the real unit labour costs trend - that is, discounting the prices effect - which underwent no significant change until 2005 (although it decreased in the EU18), but decreased after 2009 at a higher rate than in the EA18.

Figure 2 - Unit labour costs (nominal versus real; 2005=100)



Source: Eurostat.

A number of other causes further explain the increase in unemployment in Portugal in the past decade, such as labour market segmentation and the high level of employment protection for permanent contracts. Indeed, despite the 2004 employment protection reform, which introduced more flexibility in hiring and firing procedures in Portugal, Centeno and Novo (2010) remark that this reform increased flexibility in fixed-term contracts, leaving the regulation of permanent jobs unchanged – in other words, it created a two-tier labour market. However, the high level of employment protection, which was held responsible for fostering labour market segmentation and reducing labour turnover, was not the only argument used by international institutions – such as the OECD and the European Commission – to characterise the Portuguese labour market as inefficient and its regulation as unfavourable to job creation. The unemployment benefit scheme that was more generous than the EU average⁴ was perceived as contributing to the long duration of unemployment and it was claimed that rigid working-time arrangements constituted a burden on firms.

Nevertheless, rising unemployment in Portugal over the past decade – particularly in the late 2000s – is also related to global economic trends that have affected the Portuguese economy and labour market, as well as to the impact of new external shocks in the late 2000s. These global trends include changes in labour market regulation purportedly in response to increased competition in global markets and the supposed transition from a ‘Fordist’ model to a so-called ‘knowledge-based society’ (Oliveira and Carvalho 2010). These changes require a highly educated workforce and have gone hand in hand with a deterioration in conditions of employment, with job insecurity and ‘atypical’ employment coming to the fore.

Concerning the external shocks, the Portuguese economy was hit hard by the global financial crisis, which caused a recession in Portugal and the EU in 2009, as well as economic stagnation in the following years, raising unemployment in both Portugal and the EU. From 2008 to 2010, the Portuguese labour market was unable to respond to the adverse cyclical conditions caused by the global financial crisis. If we analyze the characteristics of unemployment in Portugal in the period 2008–2010, we observe that its rise particularly affected older workers (over 45 years of age), low or low-skilled workers and young workers with intermediate qualifications. According to the INE (National Statistic Office), between the third quarter of 2008 and the third quarter of 2010 the number of unemployed increased by 40 per cent among workers who had up to nine years of schooling and by more than 85 per cent among those with 12 years of schooling. By contrast, the proportion of unemployed people with higher education remained stable during this period (see Table 3). Unemployment during recessions tends to affect unskilled workers more, given their low preparedness to meet emerging labour market challenges and increasing job complexity, as production shifts to goods and services with higher technological intensity and added value (Oliveira and Carvalho 2010). Thus, Portuguese competitiveness, which in recent decades has subject to a development model based on low-skilled and low-wage jobs (Mateus 2013), has had difficulty adapting the increased competitiveness of global economies and this was translated into an increase in unemployment from 2000 (and in particular from 2008).

Table 3 ▶ Unemployed by age and level of qualification, Portugal, 2008–2010

	TOTAL POPULATION	POPULATION > 45 YEARS OF AGE	9 YEARS OF EDUCATION	12 YEARS OF EDUCATION	HIGHER DEGREE
2008Q3	423	116.7	293.8	63	66.2
2010Q3	597.4	185.5	411.9	119.2	66.2
% change	+41.23%	+58.96%	+40.20%	+89%	0%

Source: Authors’ elaboration, based on INE data.

4. According to a recent DG ECFIN study, the Portuguese unemployment benefit scheme is relatively generous in terms of unemployment insurance replacement rates and duration compared with the EU average. See Stovicek and Turrini (2012).

1.2. Labour market reform, 2011–2014

In the memorandum of understanding signed with the European Commission and the IMF, the Portuguese government committed itself to reforming the labour market with a view to tackling rising unemployment by increasing labour flexibility and cutting wages in an attempt to restore competitiveness and promote job creation. In line with the adjustment programme, significant changes were thus introduced in five key areas: unemployment benefits, employment protection legislation, working time arrangements, collective bargaining and active labour market policies. These changes were negotiated at the national level with the social partners, and led to the conclusion – in January 2012 – of a tripartite agreement aimed at growth, competitiveness and employment.⁵ The main characteristics of this reform are presented below.

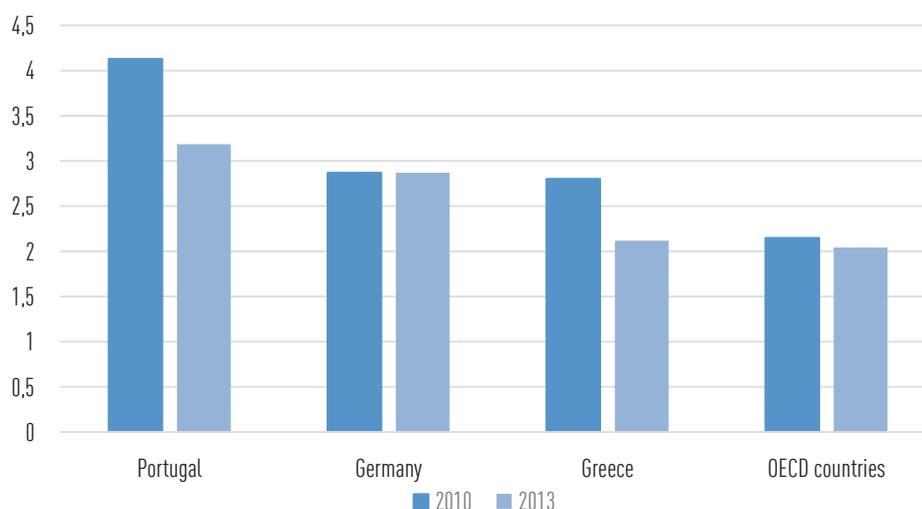
1.2.1. Employment protection

One of the main priorities of labour market reform in Portugal was to reduce the high level of employment protection (see Figure 3) and to close the gap in protection legislation between open-ended and temporary contracts with a view to tackling labour market segmentation, fostering job creation and easing the transition of workers between jobs. This was achieved by means of two main initiatives.

First, substantial cuts in severance payments (from more than 30 days of work per year before the reform to 12 days currently) and alignment of the level of severance payments for all types of contract, whether open-ended or temporary. The maximum amount of compensation is limited to 12 months and the three month minimum payment in place before the reform was eliminated.

Second, the introduction of new and less ‘restrictive’ definitions for legal dismissal of employees on open-ended contracts. Before the reform, individual dismissals were possible only if a given work position became obsolete due to the introduction of new technology and jobs eliminated in this way followed a pre-defined order of seniority. In order to increase flexibility within companies and to increase the use of open-ended contracts, the new Labour Code foresees the possibility of individual dismissal based on ‘unsuitability’ even without the introduction of new technology and eliminates the tenure rule based on seniority in case of job elimination. In addition, the government is currently considering a reduction in compensation for unfair dismissals, purportedly to strike a balance between limiting incentives to challenge fair dismissals in court and adequately penalising unfair dismissals.

Figure 3 ► Strictness of employment protection, individual and collective dismissals (regular contracts)



Source: Authors' elaboration, based on OECD.Stat, table 'Strictness of employment protection – individual dismissals (regular contracts)', http://stats.oecd.org/Index.aspx?DataSetCode=EPL_R

5. A revised Labour Code was adopted in June 2012: Law No. 23/25 June 2012.

1.2.2. Unemployment benefits

Purportedly to discourage people from remaining unemployed, the unemployment benefit system was reformed to cut both the maximum duration of unemployment benefits (from 38 to 26 months) and the maximum monthly amount of benefit (with a graduated fall after six months of unemployment). On the other hand, two measures were adopted to increase the coverage of unemployment benefit: the contribution period for eligibility was reduced (from 15 to 12 months) and the system was extended to include a clearly-defined category of self-employed (in particular, workers that obtain more than 80 per cent of their annual income from a single entity). Finally, a temporary increase (10 per cent) in unemployment benefit was put in place in the case of jobless households in which both members of a couple are not working and have children.

1.2.3. Working time arrangements

Several initiatives were adopted with a view to reducing wage costs, boosting productivity and increasing flexibility for companies. The minimum additional pay for overtime work has been cut in half and the 25 per cent compensatory time off per hour of overtime has been eliminated. Working time was also made more flexible by means of so-called 'time banks' for individual workers or groups of workers: the company can directly negotiate with the worker on up to 150 hours a year that are not paid as overtime.⁶ The government also implemented an increase in working time of up to seven days per year, cutting paid annual leave entitlement from 25 to 22 days and scrapping four national public holidays.

1.2.4. Collective bargaining

In addition to these measures targeting working time flexibility, several initiatives were adopted to promote wage flexibility. The government launched a reform of the wage setting mechanism with a view to facilitating the decentralisation of wage bargaining. The main measures adopted were (i) the end of almost automatic extension of collective agreements to non-signatory firms in the sector; (ii) the reduction of the firm-level threshold for unions to delegate to firms' works councils the conclusion of collective agreements; and (iii) the introduction of the possibility for sectoral collective agreements to include conditions under which firm-level agreements can deviate from sector-level agreements. These initiatives are expected to promote wage adjustments in line with productivity at the firm level, reducing the scope for large firms to unduly burden the competitive position of other firms in the sector.

1.2.5. Active labour market policies

During the first year of the programme's implementation, the emphasis was put on reducing employment protection and increasing flexibility. However, since 2012, the government has launched several initiatives to promote better transition from school to work (such as reform of the education system with the development of vocational education) and to ease the transition of workers between jobs through active labour market policies aimed at improving workers' employability (in particular, young people and the disadvantaged). In this context, several new programmes and initiatives, supported by EU funds, were introduced, such as a new hiring incentives programme (*Estímulo 2012*), a targeted training initiative (*Vida Ativa*), an initiative allowing for the partial accumulation of unemployment benefits and wages and programmes for tackling youth unemployment (*Impulso Jovem* and a youth guarantee scheme) (see Table 4). In addition, a plan was launched to revamp the role and functioning of Public Employment Services (PES), which includes measures aimed at improving job counselling/job search assistance and activation/sanction systems.

6. There were already 'time banks' prior to the reform but they could be activated only through collective bargaining.

Table 4 ► New programmes to ease the transition from joblessness to work, Portugal

ESTIMULO 2012 A HIRING INCENTIVES PROGRAMME	VIDA ATIVA A TARGETED TRAINING INITIATIVE	PARTIAL ACCUMULATION OF UNEMPLOYMENT BENEFITS AND WAGES	IMPULSO JOVEM	A YOUTH GUARANTEE SCHEME
This programme provides a wage subsidy for firms that hire and train unemployed people registered at PES centres for 6 months or more up to a maximum amount of 420 euros per month. The measure subsidises 50 per cent of the wage of the employee up to a ceiling equal to the social support index during the 6 months. Firms benefiting from the scheme must provide training and offer a contract of at least six months.	This initiative delivers high-employability training modules on a part-time basis, to allow the unemployed to keep actively searching for a job. The streamlined placement procedure ensures that all newly-registered unemployed attend a training module no more than 45 days after registration at a job centre.	This initiative aims at bringing into employment those that have been registered at PES centres for at least 6 months. It allows the accumulation of up to 50% of unemployment benefit, for up to 12 months, when accepting a job offer that pays gross wages below unemployment benefit.	This programme was established specifically to help unemployed young people – one of the groups most affected by the crisis – and includes: (i) internships, which provide on-the-job training to increase employability; (ii) other programmes, which include an incentive for employers through reimbursement of employers' social security contributions for younger (18–30 years old) unemployed workers and programmes aimed at promoting entrepreneurship; and (iii) SME financing activities.	The youth guarantee aims at ensuring that young people under 30 get a good-quality, concrete offer (job, apprenticeship, traineeship or continued education) within 4 months of leaving formal education or becoming unemployed.

Source: Authors' elaboration.

1.3. Reducing unit labour costs... while cutting public spending

Although reforming the wage setting mechanism was considered important to control the development of unit labour costs, the government also adopted measures aimed at immediately reducing unit labour costs. First of all, there was no increase in the Portuguese minimum wage between 2011 and September 2014 (it is the lowest among the EU15 countries and, according to Eurostat data, stood at 80 per cent of the EU28 average in 2014, as against 83 per cent in 2009). In addition, a set of initiatives was adopted aimed at reducing both unit labour costs in the public sector (and by spillover in the private sector) and public spending. All wages in the government sector were frozen in nominal terms from 2012 to 2014 and promotions were restricted. In 2011, there was a 5 per cent average cut in public sector wages (except for lower wages). In 2012, the so-called thirteenth and fourteenth month wage payments for workers with monthly wages of 1,100 euros or more were suspended. However, as the Constitutional Court ruled against this suspension, in 2013 the two bonus had to be reinstated; to compensate this reinstatement, a new progressive increase in public sector wage cuts was instituted (which replaces the wage cut already in place since 2011). Additionally, in order to increase public revenue, a general surcharge of 4 per cent of taxable income and a 2.5 per cent solidarity tax for the highest tax bracket were adopted.

Unit labour costs in the public sector were reduced, not only through wage cuts but also through an increase in working time. In addition to the increase in working time of up to seven days per year already mentioned, working hours in the public sector were raised from 35 to 40 hours per week (alignment with the private sector).

Finally, with regard to public employment, the size of the public administration was reduced by more than 8 per cent between the end of 2011 and the end of 2013 and the targeted reductions of management positions and administrative units in the central administration were 27 per cent and 40 per cent, respectively.

2. Assessing internal devaluation in Portugal

The rationale underlying the macroeconomic adjustment programme is that Portugal has suffered a major loss of competitiveness over the past decade, purportedly due to the higher increase in unit labour costs there than in its euro area partners. This trend is also taken to explain the steady deterioration of its current account balance since the mid-1990s (from a balanced situation in 1995 to a deficit above 12 per cent in 2008).

“AN INTERNAL DEVALUATION STRATEGY FOCUSING ON THE DOWNWARD ADJUSTMENT OF UNIT LABOUR COSTS AND/OR PRICES”

In order to restore national competitiveness, and taking into account that adjustment of the nominal exchange rate is not an option for the euro area member states, the macroeconomic adjustment programme rested on an internal devaluation strategy focusing on the downward adjustment of unit labour costs and/or prices. This internal devaluation was expected not only to improve national competitiveness but also, together with structural reforms, to boost potential growth and to foster job creation.

Almost four years after the adoption of the macroeconomic adjustment programme, we can make a preliminary assessment of the strategy, in terms of both its successes and failures in boosting potential growth, restoring national competitiveness (Section 2.1) and fostering job creation (Section 2.2.).

2.1. Was the strategy successful in improving competitiveness and boosting potential growth?

One way of analysing competitiveness is to explore the evolution of the trade balance; in other words, the performance of exports and imports (and the current account balance), as well as GDP and productivity growth. Based on analysis of the development of the Portuguese current account balance since 2011, we might, at first glance, assume that the internal devaluation process was successful in improving national competitiveness. Indeed, in 2013, Portugal recorded its first current account surplus in twenty years and its exports reached 40 per cent of GDP, against around 32 per cent prior to the crisis (see Figure 4). However, a deeper analysis is necessary to understand the dynamics behind this improvement of the current account balance.

Figure 4 illustrates the positive trend of the Portuguese current account balance since 2011. It is due mainly to the trend in the trade balance, with a reduction of the deficit of the balance of goods (from -19.2 billion euros in 2010 to -8.7 billion euros in 2014) and an increase in the surplus of the balance of services, mainly tourism (from 6.4 billion euros in 2010 to 10.6 billion euros in 2014), and to the positive trend in the current transfers balance (EU funds and emigrants' transfers). Nevertheless, in order to get a clear picture of the impact of internal devaluation policies on the external competitiveness of the Portuguese economy, we need to analyse the growth rate of exports and imports during this period.

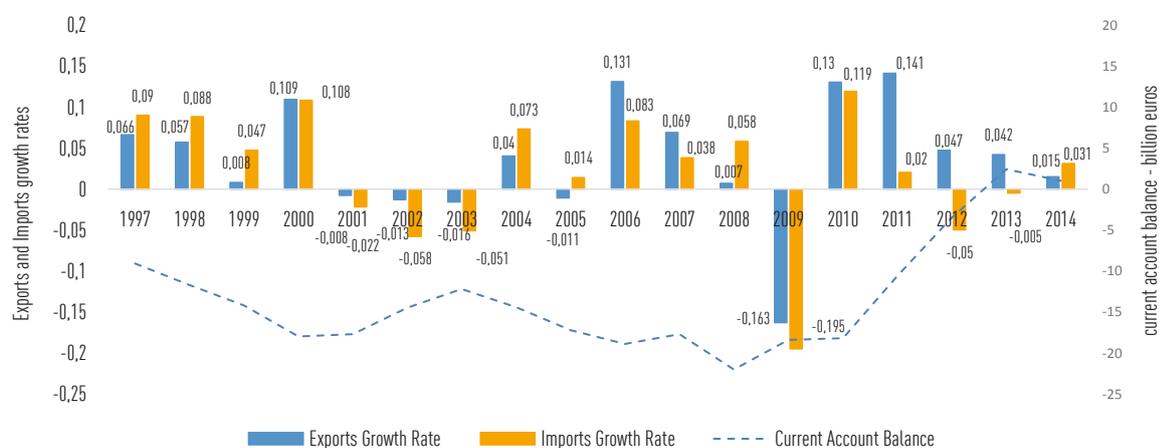
In 2012 and 2013, Portugal registered a small increase in its exports (4.7 and 4.2 per cent, respectively). However, Figure 4 confirms that this positive export trend is not new. Furthermore, the export growth rates recorded in 2012/2013 are below the levels observed before the macroeconomic adjustment programme period and in 2014 the export growth rate decreased by almost three times relative to 2013, to 1.5 per cent. Indeed, with the exception of 2008 and 2009 (during which the Portuguese economy was strongly impacted by the global financial crisis), Portuguese exports recorded a higher annual average change than in the years 2012–2013: 13.1 per cent in 2006, 6.9 per cent in 2007, 13 per cent in 2010 and 14.1 per cent in 2011⁷ (in all these years, the export growth rate was higher than the import growth rate). We can thus conclude that the positive trend of Portuguese exports after 2011 is not due to internal devaluation as it had been going on since 2006, at least.

7. We consider that the good performance of Portuguese exports in 2011 is not linked to the MoU. The programme started in mid-2011 and we can reasonably assume that it did not have an immediate impact, as the measures took some time to be implemented.

Analysing Figure 4 we notice a new trend in imports from 2011: in 2012 and 2013 there was negative import growth (-5 per cent and -0.5 per cent, respectively). This import contraction in recent years is due mainly to the strong decrease in internal demand: the gross available income of households fell by 3.7 per cent in 2011, 1.9 per cent in 2012 and 0.3 per cent in 2013, while wages decreased by 4 per cent in 2011 and 6.9 per cent in 2012, remaining stable in 2013.⁸

From this analysis we can conclude that the internal devaluation process had a huge impact on the decrease in household income, with a negative impact on domestic demand and imports, but little impact on the external competitiveness of Portuguese economy, since exports growth rates are below the levels observed before the macroeconomic adjustment programme.

Figure 4 – Exports and imports of goods and services (% change) and current account balance (billion euros), 1997–2014 (all variables in constant prices, base = 2011)

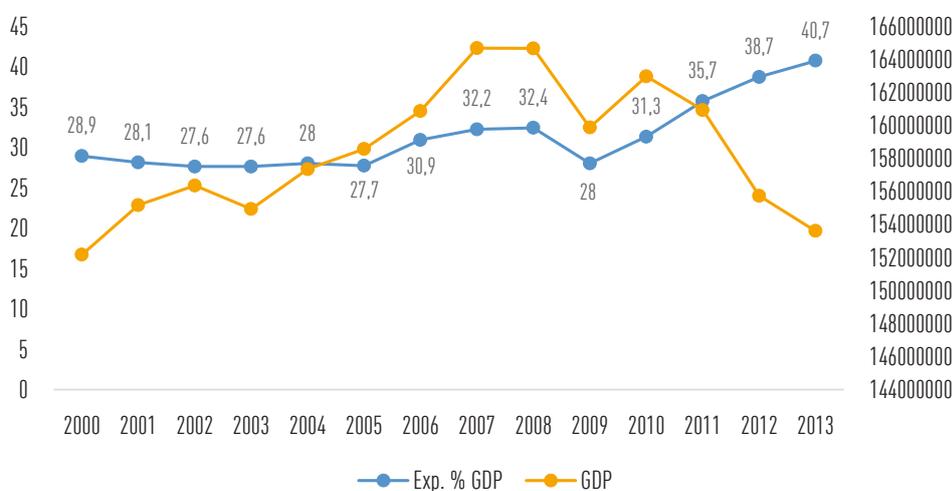


Source: Authors' elaboration, based on data from PORDATA and INE (National Statistic Office).

In addition, if we analyse the share of exports in Portuguese GDP prior to the global financial crisis of 2008, we notice a substantial increase in the exports-to-GDP ratio (from 27.6 per cent of GDP in 2002 to 32.4 per cent in 2008). In 2009, the financial crisis had a negative impact on Portuguese exports, as pointed out above, but the positive trend of the increasing weight of exports in Portuguese GDP was pursued with even greater intensity after 2009, reaching 38.7 per cent of GDP in 2012 and 40.7 per cent in 2013. There is, however, one main difference between the dynamic of the exports-to-GDP ratio recorded before and after the global financial crisis. If until 2008 the increase of the weight of exports in national GDP was due to both an increase in the export growth rate (Figure 4) and GDP growth (Figure 5), in the MoU period the increase in the export/GDP ratio was little influenced by the growth rate of exports (lower after 2011 than in the pre-crisis period, as seen above), but influenced mainly by the huge decrease in GDP during the MoU period, due to austerity policy. After an increase of almost 2 per cent in 2010, Portuguese GDP fell by -1.3 per cent in 2011, -3.2 per cent in 2012 and -1.4 per cent in 2013, contributing to a rapid increase in the share of exports in GDP.⁹

8. Data from INE (National Statistic Office) and PORDATA.
9. See European Commission (2014b).

Figure 5 ► Exports as a percentage of GDP and GDP in thousands of euro (constant prices, base=2006)



Source: Authors' elaboration, based on data from EUROSTAT/PORDATA/INE (National Institute of Statistics)

These conclusions are underlined by some experts on competitiveness, such as Professor Francisco Madelino,¹⁰ who says that 'Wage devaluation had an impact close to zero on competitiveness ... if the external balance recorded some positive developments, it is the result of the reduction of consumption - and its consequences on imports - more than the boosting of exports' (interview with the authors).

Additionally, even though a short-term negative impact of austerity policies and internal devaluation on national growth was expected when the MoU was adopted, the GDP contraction ended up being more substantial than forecast. Indeed, the MoU signed in 2011 anticipated a cumulative contraction of GDP of 2.8 per cent during the period in question; in the end, the contraction was more than twice as high (more than 6 per cent, in total). GDP per capita fell by 3.7 per cent (from 16,686 to 16,067 euros), despite the decrease of 1.1 per cent in Portugal's total population (10,542 million in 2011 to 10,427 million in 2013). We have to go back to 1999 to find a lower level of GDP per capita (15,718.8 euros).¹¹ One could argue that the short-term negative impact will be compensated by a medium-term improvement of national potential growth. However, growth prospects are not encouraging, as Portugal is expected to register growth rates in 2015 and 2016 very close to the euro area average, while Greece and Ireland are expected to grow twice such as fast as the euro area average in the next two years (see Table 5).

Table 5 ► GDP growth rate 2005-2013, projections for 2014-2016

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Euro Area	1.7	3.3	3.0	0.4	-4.5	1.9	1.6	-0.7	-0.4	0.8	1.1	1.7
Portugal	0.8	1.4	2.4	0	-2.9	1.9	-1.3	-3.2	-1.4	0.8	1.3	1.5
Greece	2.3	5.5	3.5	-0.2	-3.1	-4.9	-7.1	-7.0	-3.9	0.8	2.3	3.3
Ireland	6.1	5.5	5.0	-2.2	-6.4	-1.1	2.2	0.2	-0.3	4.3	3.3	3.2

Source: Eurostat for 2005-2013; OECD Economic Outlook (November 2014) for the years 2014, 2015 and 2016.

Finally, it was also expected in the context of the implementation of the macroeconomic adjustment programme that unit labour costs would be further reduced (in addition to the impact on unit labour costs of lowering nominal wages) through an increase in labour productivity. As we saw in Section 1, devaluation policies involved not only cuts in wages, but also cuts in work benefits, such as the elimination of vacation days and

10. Professor at ISCTE-IUL (University Institute of Lisbon). Former President of the Employment and Training Institute (IEFP). Expert in Economics and Competitiveness.

11. Source: PORDATA and INE/Banco de Portugal.

national holidays or an increase in weekly working hours. However, the available data do not illustrate a positive effect of these measures on labour productivity; the opposite effect seems to have taken place in Portugal, translated into a decrease in hourly labour productivity in the period 2011–2013 (Table 6).

Table 6 ➤ Labour productivity per hour of work (PPS, EU28=100)

	EU28	GERMANY	GREECE	IRELAND	ITALY	PORTUGAL
2000	100	124.5	75.9	114.1*	117	62.9
2005	100	127.2	76.8	120.7	103.3	63.1
2010	100	125.4	76.1*	126.2*	103.8	65.8
2013	100	126.6	74.8	122.6*	101.9	65.3

Source: PORDATA (based on Eurostat / INE - National Statistic Office) - * Provisional value.

If we consider labour productivity per hour of work, we can see a divergence between Portugal and the EU28 if we compare the situation in 2010 – before the macroeconomic adjustment programme – and in 2013 (Table 6). In 2010, labour productivity per hour of work represented 65.8 per cent of the level of the EU28, while in 2013 it represented 65.3 per cent. This divergence in productivity is similar in other countries with macroeconomic adjustment programmes, such as Ireland and Greece, and in countries implementing austerity programmes, such as Italy. This means that there was no positive impact of austerity measures on labour productivity growth in Portugal.

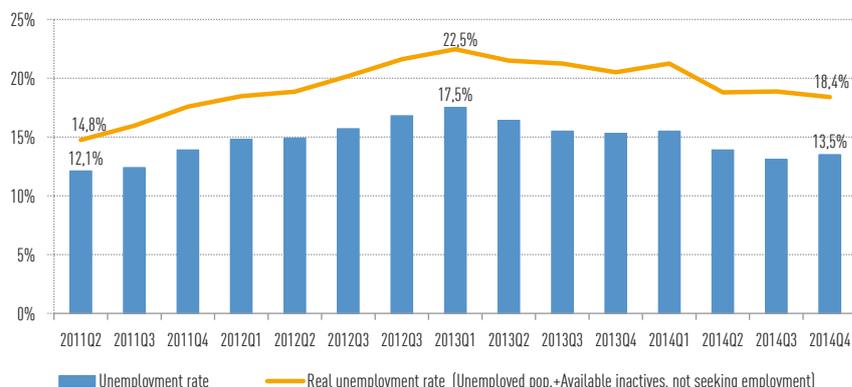
2.2. Was the strategy successful in fostering job creation?

Even though the primary aims of the MoU were to achieve fiscal adjustment and strengthen national competitiveness, its objectives also included fostering job creation in order to reverse the increasing unemployment recorded during the past decade.

The impact of the adjustment programme on unemployment was underestimated at the time the programme was adopted. Indeed, in the Macroeconomic Adjustment Programme of May 2011, it was foreseen that unemployment would peak at 12.9 per cent in 2012 and would then start decreasing. However, the picture ended up worse than expected, with the unemployment rate reaching 17.5 per cent in the first quarter of 2013.

This negative employment trend is one of the consequences of the higher than expected contraction of GDP between 2011 and 2013 (6.1 per cent against 2.8 per cent forecasted in the adjustment programme). The sharp drop in GDP is, in turn, due to a far stronger contraction in domestic demand than was predicted (-13.1 per cent against -10.5 per cent) and difficult access to credit on the part of SMEs, despite the ECB's massive injection of liquidity in the euro area. In addition to these domestic factors, the poor national economic performance of the MoU period is also explained by the fear of euro area fragmentation, which prompted a capital drain and held investors back. All these factors contributed to the deterioration of the Portuguese labour market during the implementation of the Macroeconomic Adjustment Programme.

Figure 6 ► Unemployment rate (official and real; %)



Source: Authors' elaboration, based on data from INE, Inquérito ao Emprego (National Statistic Office).

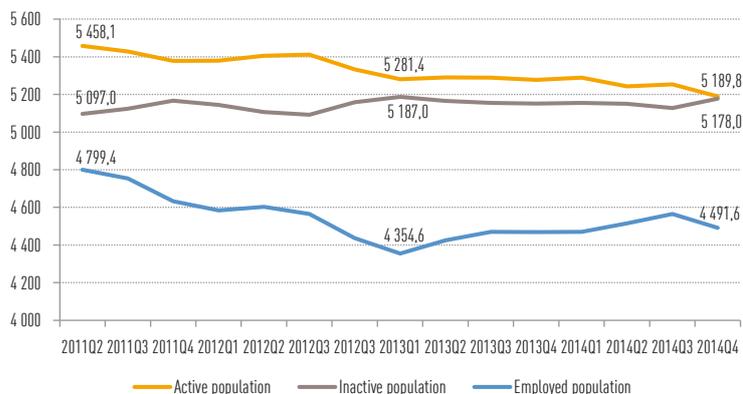
Figure 6 shows, however, that since the second quarter of 2013, the unemployment trend has reversed and there has been a steady decrease in the official unemployment rate (from 17.5 per cent in the first quarter of 2013 to 13.1 per cent in the third quarter of 2014), with an exception for the last quarter 2014 (with an increase to 13.5 per cent). Nevertheless, before focusing on the improvement in the unemployment rate in the past 18 months, we need to review the changes in the Portuguese labour market since 2011.

From the signing of the MoU in May 2011 until the last quarter of 2014, there was a profound change in the Portuguese labour market, with a reduction of the Portuguese workforce and of the number of employed people, an increase in the number of unemployed people, an increase in the number of people who left the labour market (especially people who had stopped looking for jobs and emigrants), as well as a reduction in the wage level (in both the public and the private sector).

Figure 7 illustrates the reduction in the total Portuguese workforce since the second quarter of 2011, with a decrease in the active population of 268,300 people (-4.92 per cent). This is partly due to the decrease in the Portuguese population during that period (a net reduction of about 187,000 people, corresponding to 1.77 per cent of the population), as well as to an increase in the inactive population of over 80,000 people (1.59 per cent).

The reduction of the Portuguese active population was accompanied by a decrease in the number of employed people. Between the the second quarter of 2011 and the fourth quarter of 2014 there was a net destruction of 307,800 jobs (a change of -6.41 per cent). In other words, in just over three years the labour market lost nearly a third of a million jobs, despite the improvement in job creation since the first quarter of 2013 (Figure 7). This rapid and massive net reduction in the number of those in employment increased the pressure on national public finances through its negative impact on government revenues (fewer jobs means lower tax revenues) and the increased pressure on social security sustainability (reduced contributions to the social security system and additional spending on unemployment benefits).

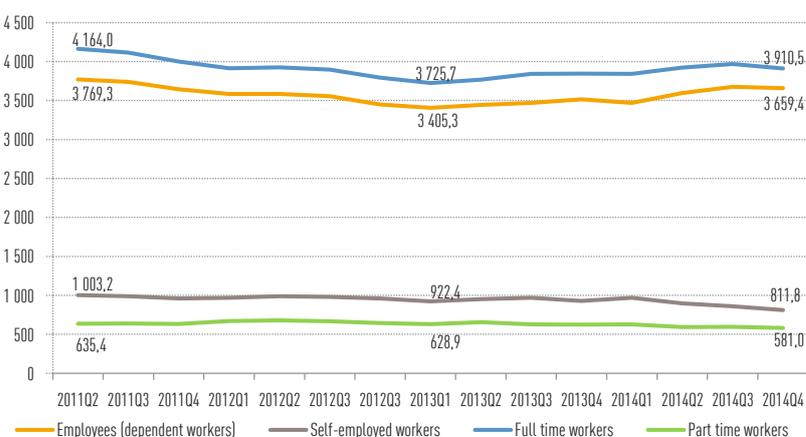
Figure 7 ▶ Active, inactive and employed population ('000)



Source: Authors' elaboration, based on data from INE, Inquérito ao Emprego (National Statistic Office, Labour Survey).

Between the the second quarter of 2011 and the fourth quarter of 2014 there was a reduction in the number of those employed in all forms of work: the number of self-employed workers was reduced by 19 per cent (-191,400 jobs), while the number of employees (dependent workers) decreased by 2.9 per cent (-109,900 jobs). Concerning type of contract, the decrease in full-time contracts was 6.1 per cent (-253,500), while the decrease in part-time contracts was about 8.6 per cent (-54,400 jobs) (Figure 8).

Figure 8 ▶ Employed population, by type of contract ('000)



Source: Authors' elaboration, based on data from INE, Inquérito ao Emprego (National Statistic Office, Labour Survey).

The number of unemployed increased significantly between the second quarter of 2011 and the first quarter of 2013, reaching a record 926,800 people (against 658,700 in the second quarter of 2011), but declining since then (with 228,500 fewer unemployed between the first quarter of 2013 and the fourth quarter of 2014). However, despite this declining trend, the global analysis between the second quarter of 2011 and the fourth quarter of 2014 indicates that there was an increase in the number of unemployed of 39,600 people in the period. If we take into account the time that people spend in unemployment, we observed an increase in the number of long-term unemployed, which represented 55 per cent of total unemployment in the second quarter of 2011 against 65 per cent in the fourth quarter of 2014, an increase of 87,100 people in that period (Figure 9). According to Gloria Rebelo,¹²

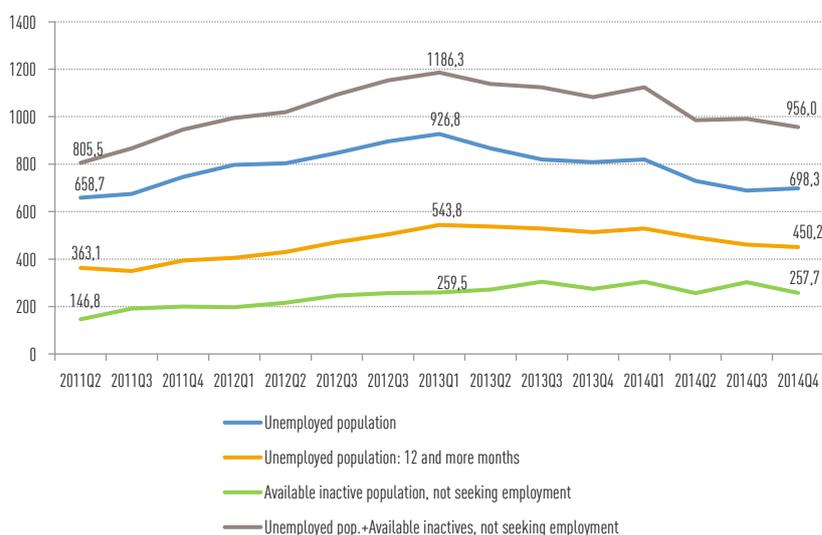
many companies, seeking to reduce labour costs, chose to finish job contracts with older workers (linked to higher salary base) and replace them by hiring younger workers with lower wages. However, this type

12. Professor at Universidade Lusófona de Humanidades e Tecnologias and expert in labour market and training policies.

of decision generates a strong wage compression, triggering a disturbing rise in unemployment – particularly long-term unemployment. (Interview with the authors)

Additionally, we have witnessed a large increase in the past three years in the number of ‘available inactive people’, that is, people who are available to work but who have given up looking for a job; in other words, ‘demotivated’ people who are not registered in the official unemployment statistics. If in the second quarter of 2011 such people represented about 22.3 per cent of total unemployment (146,800 people), in the fourth quarter of 2014 they represented 36.9 per cent (257,700 people). This means that the total number of people in Portugal without a job – but available to work – is almost 1 million (Figure 9). This has an impact on the unemployment rate, which was officially 13.5 per cent in the fourth quarter of 2014 (11.6 per cent higher than in the second quarter of 2011), but stands at 18.4 per cent if we count ‘demotivated’ people, representing a 24.3 per cent higher rate than in the second quarter of 2011 (Figure 6).

Figure 9 ▶ Unemployed and available inactive population (‘000)



Source: Authors’ elaboration, based on data from INE, Inquérito ao Emprego (National Statistic Office).

If there has been an improvement in the Portuguese labour market since the second quarter of 2013 (which is illustrated by the decrease in the official unemployment rate from 17.5 per cent to 13.1 per cent as well as the increase of about 4.8 per cent of the employed population), this trend is hard to explain taking into account the performance of the Portuguese economy in the past two years. Indeed, an economic recession of 1.4 per cent in 2013 and expected GDP growth of 0.8 per cent in 2014 are hardly compatible with a decrease of about 25 per cent in unemployment. In this context, Subir Lall, of the IMF, stated in an interview for a Portuguese newspaper in November 2014: ‘I think nobody understood how the unemployment rate is dropping’.¹³ The growth in the available inactive population – ‘demotivated workers’ – in the past three years and a half is certainly part of the explanation.

There are, however, two other important trends that contribute substantially to the reduction in the number of unemployed people in Portugal. On one hand, we cannot neglect the impact of emigration on the improvement of the Portuguese labour market. As already pointed out, the Portuguese population has decreased by 1.64 per cent and the active population by 3.74 per cent since the second quarter of 2011, reflecting the high increase in emigration between 2011 and 2013, when about 150,000 long-term emigrants left the country (Table 7). The number of annual long-term emigrants from Portugal increased by more than 200 per cent between 2009 and 2013. This trend naturally alleviates part of the pressure on the Portuguese labour force. The challenge for the

13. See the interview with Subir Lall in the *Jornal de Negócios* on 10 November 2014.

years to come, however, is to establish the conditions that would persuade these emigrants to come back to work in their home country and reverse the youth/brain drain that, according to some economists, has taken place in Portugal in recent years. We need to point out, however, that emigration has not hit Portugal as heavily as it has hit Ireland and Greece. Indeed, Greece recorded three times more long-term emigrants in 2012 than Portugal (even though the total population of the two countries is about 10 million people).

Table 7 ▶ Long term emigration from Portugal, Greece and Ireland, 2009–2013

	2009	2010	2011	2012	2013
Portugal	16,899	23,760	43,998	51,958	53,786
Greece	–	119,985	125,984	154,435	–
Ireland	69,672	78,099	87,053	89,436	–

Source: Authors' elaboration, based on data from Eurostat and PORDATA for Portugal in 2013.

On the other hand, we need to pay some attention to the trend in public employment and the impact of active labour market policies. When we analyse the trend in public employment in Portugal in the past five years, we notice that public employment has suffered substantially, although the trend was reversed in the first quarter 2013, since when the public administration has been creating new jobs. In the second quarter of 2013 there were 286,900 public employees (as against 348,700 in the second quarter of 2008) and in one year there was an increase in public employment of about 9 per cent (313,000 in the second quarter of 2014). This trend is similar to the one in general employment, as outlined above. Between the second quarter of 2013 and the second quarter of 2014, about 90,000 jobs were created in Portugal, including about 26,100 new jobs created by the public administration (Table 8). We thus need to acknowledge the importance of public employment in job creation in Portugal in the past 18 months. Additionally, a study by the Portuguese Central Bank puts in evidence the importance of active labour market policies in job recovery in Portugal. The study concludes that job creation in the private sector increased by about 2.5 per cent between the third quarter of 2013 and the third quarter of 2014; more than one-third of this increase (0.9 percentage points) concerns professional training promoted by the public employment agency.¹⁴

Table 8 ▶ Employees in the public administration, defence and social security, 2008Q2–2014Q2

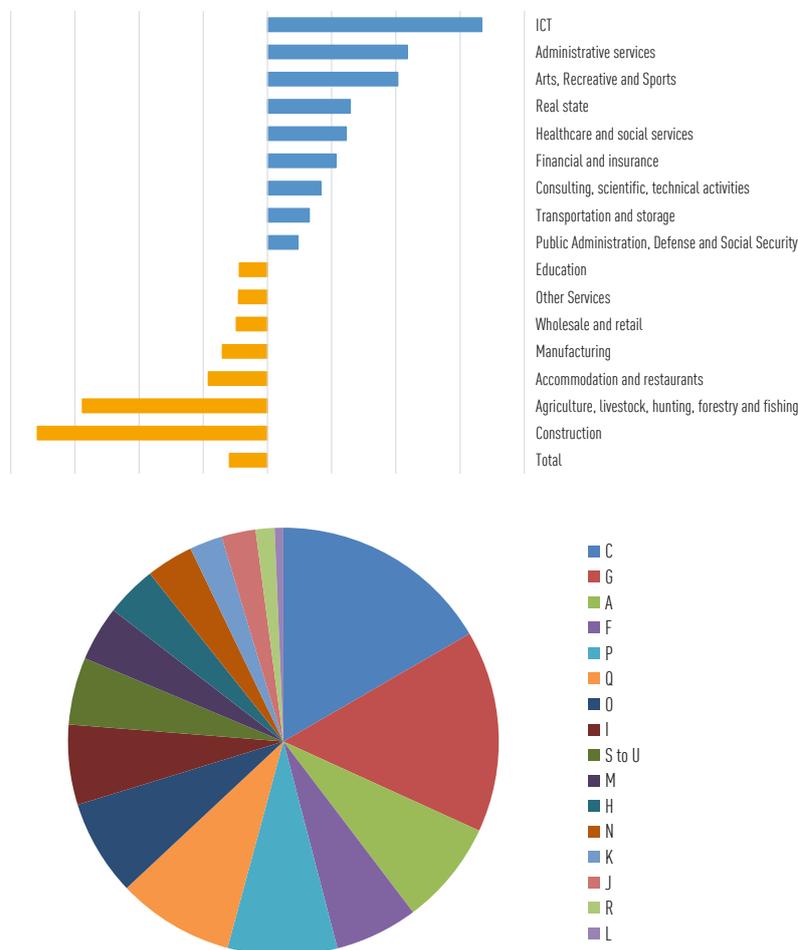
	2008Q2	2011Q2	2012Q2	2013Q2	2014Q2
Employed population	5149	4799.4	4602.7	4424.6	4514.6
Employed population in the Public administration, Defence and Social Security	348.7	303.2	293.8	286.9	313

Source: Authors' elaboration, based on Eurostat data.

Finally, we need to pay some attention to the relative change in employment by sector between 2011 and 2014. At the end of 2014, manufacturing and wholesale/retail trade employed most people, at 16.4 per cent and 15 per cent, respectively. Despite a decrease in employment in these two sectors between 2011 and 2014 (of 7 per cent and 5 per cent, respectively), their share of employment remained stable. The two sectors that recorded the largest relative losses were construction (–36 per cent) and agriculture (–29 per cent). While in the first quarter of 2011 agriculture ranked third in the Portuguese economy in terms of people employed and construction fourth, by the end of 2014 they had fallen to fifth and sixth places, respectively (Figure 10).

14. Banco de Portugal (2014), pp. 26–28.

Figure 10 ► Distribution of employment across NACE2 sectors in the fourth quarter of 2014 and relative change in employment by NACE2 sectors (between the first quarter of 2011 and the fourth quarter of 2014)



Key: A=Agriculture, Forestry and Fishing, C=Manufacturing, F=Construction, G=Wholesale and Retail Trade; repair of motor vehicles, H=Transport and Storage, I=Accommodation and food service activities, J=information and communication, K=Financial and insurance activities, L=Real Estate activities, M=Professional, scientific and technical activities, N=Administrative and support service activities, O=Public administration and defence; compulsory social security, P=Education, Q=Human health and social work activities, R=Arts, entertainment and recreation, S to U=Other services.

Source: Authors' elaboration, based on data from INE, Inquérito ao Emprego (National Statistic Office)

Figure 10 shows that only half of the sectors of the Portuguese economy recorded a decrease in employment between the first quarter of 2011 and the fourth quarter of 2014, but it must be pointed out that the four sectors that recorded the highest losses represented more than 40 per cent of total employment in 2011, while the four sectors that recorded the highest increases (information/communications (+33 per cent), administrative and support service activities (+22 per cent), arts/entertainment/recreation (+20 per cent) and real estate activities (+13 per cent)) represented only 5.5 per cent of total employment in that year. Despite the cuts in public administration jobs during the adjustment programme, public employment increased in that period, contributing to job creation in 2014.

3. Strengthening competitiveness and reducing unemployment in Portugal – defining a new strategy

In the previous section we presented a short assessment of the internal devaluation strategy pursued in Portugal since 2011. Given the only sporadic success of the strategy, we can question whether or not it was the approach to boosting national competitiveness and fostering job creation. With an unemployment rate reaching 13.5 per cent at the end of 2014, creating new and better jobs is undoubtedly one of Portugal's main challenges for the years to come. This high level of unemployment not only has a negative impact on national economic performance but is also an obstacle to social inclusion and the consolidation of public finances. Even if we acknowledge that increasing labour market flexibility can help to reduce labour market segmentation and stimulate job creation, it is doubtful that labour reform will be successful if it is not part of a comprehensive strategy to renew the national economy and labour market. This means pursuing a strategy of improving the qualifications of the labour workforce and fostering innovation to increase productivity and develop new sectors of activity to replace those in which the economy is no longer able to be competitive at the global level due to the strengthening of Asian and central and eastern European competition (such as labour-intensive goods).

3.1. Calling into question the principle of internal devaluation

The assumption that wage reductions will increase the competitiveness of the Portuguese economy is at least questionable. It should be noted that company wage costs in Portugal (including salaries and social security charges) represent only 21 per cent of their production costs (Table 9). This means that a wage reduction of 10 per cent – with all the rest remaining constant – would have a potential impact on final output value of only 2.1 per cent. It is also noteworthy that in 2011, about 66 per cent of Portuguese companies' production costs were intermediate costs, such as the costs of raw materials, energy, transport and communications (Almeida and Caldas 2014). Thus, we can call into question the rationale of the strategy pursued between 2011 and 2014 which led to the adoption of measures oriented to cut wages and labour costs, while at the same time no effective measures aimed at cutting context and intermediary costs (for example, utilities) were adopted.

Table 9 ▶ Activities of enterprises (Portugal, 2011) (billion euros)

	2010	2011
Turnover	401.3	389.8
Production	243.6	239
Gross added value	88	82.2
Wage costs (wages + social contributions)	52.2	50.9
Gross operating surplus	36.3	31.6
Operating results	20.1	5.4

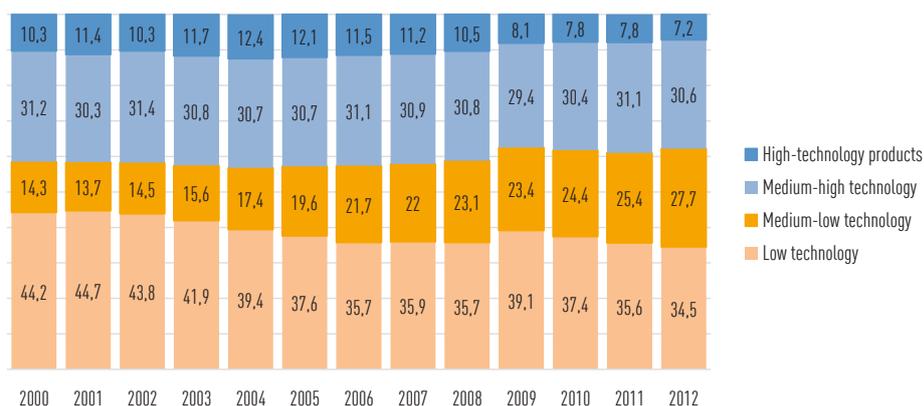
Source: INE (National Office of Statistics), Empresas de Portugal, 2011.

If we analyse only export companies, the conclusion is similar: wage costs represent about 33 per cent of their production costs, which means that a 10 per cent reduction in wages would have an impact of only 3.3 per cent in reducing export prices. Thus, by hypothesis, to achieve an improvement of 20 per cent in external competitiveness, wage costs would have to be reduced by about 60 per cent (Amaral 2010). These data show that wage devaluation (via wage reduction) would not have a significant effect on enterprise competitiveness (neither internally or externally). Rather, wage reduction is likely to have a negative impact on firms because a fall in available household income has a direct impact on domestic demand; in other words, it directly affects companies' sales – not to mention potential issues related to delays in the payment of household debt and other social costs (Amaral 2010; Almeida and Caldas 2014). This question becomes even more important if we consider

that about 95 per cent of Portuguese companies do not export and so are entirely dependent on the domestic market (INE 2014).

Thus, it seems that increasing the competitiveness of domestic enterprises is more dependent on other variables than wage reduction. In this context, we need to take into account the characteristics of the Portuguese productive structure, which specialises mainly in low and low-medium technology. In 2011, 77.6 per cent of the gross added value of manufacturing sectors was based on the low and medium-low technological sectors, with medium-high technology sectors representing only 18.4 per cent (in 2010) and 14.3 per cent of employment in 2011 (FCT 2013). In a long-term perspective, if we analyse the evolution of the export profile, we see a clear improvement of the technological specialisation between 1990 and 2000 (Amaral 2011; Salavisa 2000) and a stagnation in the period 2000–2012. On one hand, the weight of exports of low and medium-low technology products decreased from 72.6 per cent (in 1990) to 58.5 per cent (in 2000); on the other hand, between 2000 to 2012 this figure stagnated at around 60 per cent, reaching 62.2 per cent in 2012 (Figure 11), meaning that there was no change in the structure of the productive specialisation in the 2000s. Moreover, since the international crisis of 2008 the share of exports of high and medium-high technological products has decreased.

Figure 11 ► Exports of industrial products, by level of technology intensity



Source: GEE (2013)/MEE - Ministry of Economy and Employment and INE - Estatísticas do Comércio Internacional.

The exception with regard to Portuguese exports are knowledge-intensive services, where there has been a change in the pattern of specialisation over time. Portugal had a surplus in the balance of technological payments for the first time in 2007 and has maintained a positive balance since then (except for 2010). This means that, since 2007, Portugal exports more technology and knowledge-intensive services than it imports (Santos 2014).¹⁵

Besides the specialisation profile of the Portuguese economy, it is also important to consider other structural problems that have conditioned its competitiveness (Mateus 2013). These include the following: the low level of formal education of the population in general (despite the efforts undertaken in the 2000s in education, 64 per cent of the population had at most nine years of schooling in 2011 as against 30 per cent in the EU27 – see Table 10); business characteristics (50 per cent of company owners have no more than six years of schooling; 95 per cent of Portuguese companies do not export¹⁶); and there are systemic problems in the national innovation system (FCT 2013). If it is true that higher levels of formal education do not bring about an immediate increase in productivity and competitiveness (there may be adjustment problems in the labour market and mismatches between education and the needs of the economy, in the short term), it is also true that higher levels of formal education lead to higher levels of qualifications in the labour market in the long term (Almeida et al. 2009). In addition, in open economies, exposed to international competition, education and qualifications are essential

15. Antonio Bob Santos, "Opinião: Exportações de serviços de conhecimento batem recorde em Portugal", April 2014

16. INE (2014).

to increase R&D levels, generate innovative products and services and strengthen national competitiveness in the long term (Ladd 2012; Krueger and Lindahl 2001; West 2012). That is why the reinforcement of education and training policies in Portugal, not only at a general level but also oriented to innovation and knowledge-intensive activities, is important. This is a key condition to guarantee higher levels of competitiveness in the long run (OECD 2014a). Taking these constraints into consideration, Portugal needs an ambitious and comprehensive strategy aimed at addressing these structural problems in the medium-term.

Table 10 ► Attainment level of people 15–64 years of age (%)

EDUCATION LEVEL		2007	2008	2009	2010	2011
Basic education (ISCED 0-2)	EU (27)	32.90	32.20	31.60	30.80	30.00
	PT	71.30	70.60	69.10	67.10	63.80
Secondary and post- Secondary Education (ISCED 3-4)	EU (27)	46.50	46.60	46.40	46.50	46.40
	PT	16.7	16.7	17.8	19.1	20.6
Tertiary Education (ISCED 5-6)	EU (27)	20.60	21.20	22.00	22.70	23.60
	PT	12.00	12.70	13.10	13.80	15.60

Source: Authors' elaboration, based on Eurostat data.

Despite these structural problems, in the 2000s Portugal made significant progress in terms of innovation capacity, although it remained below the EU27 average, according to the IUS 2014 Innovation Union Scoreboard (European Commission 2014a). In the period 2006–2010, Portugal was third in the EU27 with regard to progress made in terms of innovation, at an average annual rate of 7.2 per cent (European Commission 2013: 16), clearly converging with the EU27 average. However, since 2011 Portugal has been lagging behind the EU27 again, with the index value of innovation in Portugal decreasing from 79 per cent in 2010 to 74 per cent of the EU27 average in 2013 (European Commission 2014a), which coincides with the MoU period. In Table 11 we can see that Portugal's position in the IUS has dropped since 2010, the year in which Portugal achieved its best position.

Table 11 ► Innovation Union Scoreboard – Portugal's performance, 2006–2014

	EIS 2006	EIS 2007	EIS 2008	EIS 2009	IUS 2010	IUS 2011	IUS 2013	IUS 2014
Portugal's position in the EU27 innovation ranking	22 ^o	22 ^o	17 ^o	16 ^o	15 ^o	16 ^o	17 ^o	18 ^o

Source: Authors' elaboration, based on data from European Commission, European Innovation Scoreboard/Innovation Union Scoreboard (Reports 2006-2014).

The decrease in Portugal's innovation capacity in the troika period can be understood by analysis. The data available from DGEEC (2014) show that total R&D expenditure (public and private) decreased from 1.6 per cent of GDP in 2010 to 1.41 per cent in 2012, a decline of almost 440 million euros (-16 per cent), despite the sharp fall in GDP in that period. The reduction of R&D expenditure was transversal to all entities: companies invested less than 10 per cent in R&D in the period 2010–2012, public entities saw a cut of 37 per cent, higher education institutions a cut of 17 per cent and non-profit private institutions invested less 30 per cent. These figures led to the loss of over 2,000 jobs in R&D (full-time equivalent) between 2011 and 2012, half of whom worked in public R&D institutions. Thus, the cuts made in R&D in the period 2010–2012 compromised some of the advances that Portugal achieved in the 2000s. It is well known that the best performing countries in this area are those that invest continuously in R&D and qualifications, as well as in attracting qualified immigrants (DGEEC 2014). Furthermore, when we consider that a country's long-term economic growth depends on its innovative capacity (Foray 2009), we can see Portugal innovation's performance since 2011 as a problem.

3.2. Looking forward: which way for more and better jobs in Portugal?

As outlined in Section 1, according to the assessment of the European Commission and the IMF, the main causes of the rising unemployment trend in Portugal were the deterioration of unit labour costs during the past decade and the rigidity and inefficiency of the labour market. Even though the macroeconomic adjustment programme signed in 2011 identifies other causes of rising unemployment in Portugal since the introduction of the euro - in particular, the low education level and other macroeconomic features - it does not give

“THE STRATEGY SHOULD HAVE BEEN FOCUSED ON MEASURES AIMED AT INCREASING LABOUR PRODUCTIVITY GROWTH”

them the importance they deserve in the design of the reform programme for the national economy. Indeed, despite recent increases in PISA educational achievement scores in 2009 and 2012 (highlighted by the OECD as a result of public policy reforms in education in the 2000s), the Portuguese economy suffers from a low skilled work force (about 60 per cent of the population had at most nine years of schooling). This is particularly worrying as in the past decade the Portuguese economy has recorded a loss in market share for labour-intensive goods, as Asian and central and eastern European competition have strengthened, and it thus needs to develop new economic activities, which will certainly require an upgrade in labour force qualifications. In addition, the country suffers from problems concerning the transition from education to the labour market (role of education) and between jobs (role of active labour market policies). These problems were duly recognised in the macroeconomic adjustment programme signed in 2011; however, the reform of the education system was driven mainly by the need to reduce public spending. In fact, total education expenditures represented 5.6 per cent of GDP in 2009, decreasing to 4.9 per cent in 2013, despite the decrease of GDP in that period. Public expenditure on basic and secondary schools decreased from 5 billion euros (2010) to 3.9 billion euros in 2012 (CNE 2014: 7). Instead of pursuing an improvement in unit labour costs through a reduction in nominal wages, the strategy should have been focused on measures aimed at increasing labour productivity growth (which would not be reflected in wage growth until unemployment falls).

One of the consequences of the strategy pursued in recent years is that it has fed a growing consensus that the aim of improving the competitiveness of the Portuguese economy is not compatible with an austerity policy based on wage depreciation and maintenance of low wages. The President of the Portuguese Economic and Social Council (which brings together representatives of companies and workers), Silva Peneda, says that ‘Competitiveness today is not a function of wages ... but it is more a function of how companies are managed and of the reduction of auxiliary costs’ (23 December 2014 in TSF Forum).¹⁷ This position contrasts with the one taken by the Troika since 2011, but it is in line with the strategy defended over time by various experts on competitiveness.

For example, Fernandes (2014) states that Portugal should develop a new cycle of policies based on innovation and knowledge, taking advantage of the investments made in the past 30 years in the modernisation of basic infrastructure, workforce qualifications and development of scientific and technological capacity. Also for Godinho (2013) and Mateus (2013), competitiveness must be based on innovation and productive differentiation, efficiency and modernisation of public services, internationalisation of companies and orientation of production for global markets, strategic cooperation between various economic actors and workforce qualifications. Competitive dynamics and improving the specialisation profile of the Portuguese economy are essential to boost growth and reinforce social and territorial cohesion (cohesion and competitiveness are two sides of the same coin (Mateus 2013). These two conditions are, in turn, key conditions for creating more and better jobs, as well as for consolidating public finances. Francisco Madelino, former President of the Portuguese Employment and Training Institute (IEFP), shares this position, stating that:

The main problems that arise in improving competitiveness are due mainly to weaknesses in human capital, cuts in training and education, difficult access to credit, energy costs, weak links between companies

17. Silva Peneda, “Relatório de Bruxelas sobre Portugal é «uma forma de pressão»”, December 2014

and universities, the functioning of the courts, extremely time-consuming licensing procedures – all of which have been aggravated in recent years – problems of judicial reform and in the restrictions imposed on filling vacancies in the public administration. (Interview with authors, November 2014)

Criticism of the wage depreciation policy as a way of creating jobs is also underlined by Gloria Rebelo,¹⁸ who states that ‘job creation is dependent on the economic growth of the country. We must strengthen the capacity to invest – not only private but also public investment – and attract foreign direct investment’ (interview with the authors, November 2014). In this context, also Mario Draghi (President of the European Central Bank) recognises that economic growth and sustainability of public debt cannot be achieved without adequate public policies that encourage investment, welcoming the investment package proposed by new European Commission to stimulate growth in the EU: ‘Moreover, using EU funds more effectively to boost both current demand and future potential – which means raising investment – would have a similar effect on growth and debt sustainability. I therefore welcome the Commission’s new proposal to stimulate investment spending in Europe.’¹⁹ Ordóñez, Sala and Silva (2014) also mention innovation and technology investment as the way to foster growth: ‘technology is the right way to ensure stable long-run economic growth. This would explain why, despite the PIIGS’ [Portugal, Italy, Ireland, Greece and Spain] efforts to reduce their real unit labour costs, they have been unable to converge with the core euro-zone economies’ (Ordóñez et al. 2014: 26).

In brief, if it is to promote sustainable growth, consolidate public finances and create more and better jobs, Portugal needs a new medium-term strategy focused on public policies that support innovation, workforce qualifications, the promotion of knowledge and changes in the specialisation profile of the economy towards higher added value activities (such policies were on the national reform agenda prior to 2011). This does not mean that fiscal consolidation is not important, but it will be achieved only with a dynamic and innovative economy that values its endogenous resources, boosts economic growth and creates jobs (and not through blind austerity and internal devaluation policies).

4. Final remarks

Until the international crisis of 2008, Portugal had a relatively low unemployment rate and public debt was in line with the EU average. The financial crisis led the EU member states to adopt interventionist measures to rescue the financial system, through the injection of public funds and this had a negative impact on national public deficits. The impact was more substantial on smaller economies and those that were more vulnerable to external shocks, such as the Portuguese economy. The external shocks in the 2000s and the crisis of 2008 helped to bring Portugal’s structural problems to the fore, including:

- a very low level of economic growth during the past decade;
- a low level of qualifications among the majority of the Portuguese population;
- a productive specialisation profile based in low and medium-low technology;
- a low incorporation of technology and knowledge in most exported goods, generating low levels of added value (despite the positive trend of exports in the past two decades); and
- concentration of exports in a small number of companies (95 per cent of Portuguese companies do not export).

¹⁸. Professor at Universidade Lusófona de Humanidades e Tecnologias, expert on labour market and training policies.

¹⁹. Mario Draghi, *Speech by Mario Draghi*, November 2014.

These structural problems, highlighted by the effects of the global financial crisis, provided the ideal conditions for working out an adjustment programme for Portugal (MoU) based on restrictive budgetary and financial measures, as well as an internal devaluation strategy, which were expected to lead to economic recovery and job creation.

We have analysed the impact of the internal devaluation measures introduced in Portugal during the MoU period (May 2011 to May 2014). We have outlined that the initial objectives set out in the MoU were not achieved: the public deficit is still above 3 per cent of GDP; public debt has increased by almost 30 percentage points (up to 130 per cent of GDP); export growth rates are lower than before the implementation of the MoU measures; GDP growth is stagnant after three consecutive years of recession (2011-2013); and more than 18 per cent of the active population has no job. In addition, there has been no change in the economy's specialisation profile, the technology intensity of exports or labour productivity. Furthermore, Portugal's innovative capacity has decreased to the levels of 2007. By the end of 2014 the country's labour market had shrunk as a result of emigration, unemployment and the number of demotivated people who had simply given up looking for a job. Also important is the social impact of the implementation of MoU austerity measures, reflected in the increase in the poverty rate and social inequalities since 2011.

“ A COMPETITIVE AND INNOVATIVE ECONOMY TO FOSTER A JOB-RICH RECOVERY”

As a result, it has been recognised – at both national and international level – that a new generation of public policies is needed to stimulate economic growth, through innovation, technological modernisation, workforce qualifications and modernisation of public services. These are key conditions of tackling the high level of structural unemployment in the Portuguese economy. The working out of public policies in the period 2015-2020 must take full advantage of the available EU funds to support its new medium-term growth strategy:

- Portugal will benefit from a new package of structural funds until 2020 (about 20 billion euros), aimed at supporting projects related to economic competitiveness, workforce qualifications and social cohesion;
- A new package of European funds for innovation and R&D is available until 2020, with about 80 billion euros provided by Horizon 2020, the EU Framework Programme for Research and Innovation (Portuguese companies and entities can benefit from these funds);
- Portugal may also benefit from the investment plan (public and private) of the new European Commission, estimated at 315 billion euros.

Additionally, Portugal needs to take proper advantage of the quality of its basic infrastructure, particularly the communications network, the network of science and technology, people with advanced training and the entrepreneurship and business innovation network constructed in the past two decades.

To conclude, there are several factors favourable to the development of policies in the coming years to stimulate economic growth, improve the qualifications of the Portuguese population and boost job creation and social cohesion. Portugal now needs its political leaders²⁰ and economic actors to utilise them fully and to create a new dynamic for a competitive and innovative economy to foster a job-rich recovery.

20. A new political cycle has begun in Portugal with the legislative elections in October 2015, and the Presidential elections will take place in January 2016.

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