

Foreword

The essays collected in this volume were presented at the conference “Challenges Ahead for the Portuguese Economy” held in Lisbon on the 15th and 16th of December 2006. This conference was intended to be both a “Remembrance of the MIT 1974-1977 Missions to Portugal” and an opportunity to have a forum discussion on the current situation of the Portuguese economy. The papers are arranged by sessions, in the same order in which they were presented during the conference – each session tackling one or two topics.

The introduction by Silva Lopes, who initiated the original Massachusetts Institute of Technology (MIT) missions to Portugal, opens the conference and draws attention to the most immediate challenge facing Portugal: the difficulty of restoring competitiveness without recourse to deflation.

The first session, “Achievements and Challenges”, starts with an historical retrospective by Richard Eckaus, *Professor Emeritus* at MIT and the American counterpart of Silva Lopes in the organization of the original MIT missions. Eckaus describes the great social and economic changes in Portugal that have been seen in the last thirty years. He then offers a lucid view of the current situation, stressing high income inequality and poor education level relative to other European countries.

The second session “Growth, Productivity and Wages” was originally scheduled to be hosted by Robert Solow, *Professor Emeritus* at MIT and Nobel Prize laureate in economics, who had to decline at the last minute. The first paper, by Pedro Lains, economic historian at the *Instituto de Ciências Sociais*, presents a comparison on the growth and productivity performance of Portugal and Ireland. Lains stresses the differences in the structure of employment across all industries to

explain the different performances of Ireland and Portugal over the last thirty years, concluding that these differences are associated with different endowments of physical and human capital. The second paper, by Pedro Portugal, labor economist at the Bank of Portugal, describes wage setting in Portugal. The author starts by downplaying “the economic model based on low wages” and then provides a very careful description of various aspects of wages in Portugal. In particular, he stresses the importance of the minimum wage on the pattern of wage distribution, the evidence of a wage cushion paid by firms over and above the negotiated wage, which allows for wage flexibility, and goes on to show empirically that Portugal is a country of extreme nominal rigidity. The third paper, by Francesco Franco, macroeconomist at the *Universidade Nova de Lisboa*, starts with a discussion of Lains’ paper. Franco revisits Lains’ conclusions and suggest that the main culprit in the difference in performance between Portugal and Ireland resides in factors pertaining to the ease of adoption in the transmission of technology, such as rigidities in the labor market that do not allow the restructuring in a country to flow at the pace of a technology shock.

The third session, “Life in a Currency Union”, tackles the theme of the large current account imbalances. The first paper, by Olivier Blanchard, MIT professor, argues that the current account deficit that we observe in Portugal, as in other rich countries, is quite different from the previous imbalances that were typical in poor countries. Today deficits are driven primarily by private savings and investment decisions rather than fiscal deficits. Blanchard then questions the role of policy in the presence of distortions in the labor, goods and financial markets. In order to do so, he develops a novel conceptual framework. His first conclusion is that optimal policy is never geared to decreasing deficits *per se*. He then focuses on the Portuguese current account in particular, arguing that Portugal faces an unusually tough economic challenge: low growth, low productivity, high unemployment, and large fiscal and current account deficits. He suggests that a decrease in nominal wages will do most of the job of a successful devaluation and can substantially decrease the costs of a slow adjustment that must necessarily go through unemployment. The second paper, by Francesco Giavazzi, professor at Bocconi University, discusses Olivier Blanchard’s paper and uses it to compare Ireland and Portugal. The third paper, by Luís Campos e Cunha, professor at the *Universidade Nova de Lisboa*, argues that the current account deficits are the necessary response to transfers and (especially) wealth effects induced by the access to the euro. On the

other hand, fiscal deficits are not desirable and are related to the low performance of Portugal. He ends by arguing that wages are market determined and should not be used as policy instruments, as suggested by Blanchard.

The fourth session addresses two areas. The first, “Health and Social Security”, starts with a paper by Pedro Pita Barros, professor at the *Universidade Nova de Lisboa*, on the current status of the health system in Portugal. Pita Barros reviews the main features of recent expenditure growth in healthcare, looks at the major policy changes in recent years, and stresses the peculiarities of the Portuguese system. The second paper, by Jeremy Bulow, professor at Stanford University, speaks to the pressing challenge of social security. Bulow compares the US and Portuguese public and private sector pensions. He identifies elements of recent reforms that can improve the incentives to remain longer in the labor force. He also describes how the US private system went from a half-trillion dollars reported surplus to an equally large deficit in only a few short years following the burst of the stock market bubble, an event that underscores the fragility of the system in place in the US and provides guidance on how to design a more robust system in Portugal.

The second half of the fourth session (indicated as “V” in the text), “The role of economic advising”, starts with a paper by Jorge Braga de Macedo, professor at the *Universidade Nova de Lisboa*. Braga de Macedo provides three different examples of economic advice that reflect the legacy of the MIT group’s activities in the mid-1970s. The second paper, by Paul Krugman, professor at Princeton University, recalls the role of the first MIT missions in Portugal, in which he participated. Krugman goes on to describe what he calls “the heroic age of international advising”, a period in which western economists would travel the world offering policy advice to countries in transition. He concludes that though this period has drawn to a close, there might still be a role for outsiders: breaking the “incestuous amplification”.

Francesco Franco