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1 Introduction

This conference has its roots in the MIT missions that took place 30 years ago which advised the Ministry of Finance (in early 1975) and the Bank of Portugal (from 1975 to 1977) on the formulation of the macroeconomic policies required to address the difficult situation in which the Portuguese economy found itself at the time.

The present gathering was assembled in memory of those missions, but it also has a more pragmatic purpose – that of creating an opportunity for obtaining the views on the current economic situation from a group of economists, renowned throughout the world, who are linked to the MIT through their present or past work.

We had a similar conference in 2001, which was sponsored, as is this one, by the Gulbenkian Foundation, the Luso-American Foundation, and the Bank of Portugal. I must express the gratitude of the Organizing Committee to the Presidents of those three institutions – Dr. Rui Vilar, Dr. Rui Machete and Prof. Vitor Constâncio – for their generous support, which has made these events possible. We have with us today three members of the original MIT missions (1974-1977) – Professors Richard Eckaus, Paul Krugman and Jeremy Bulow. We also have two current professors with MIT connections – Olivier Blanchard and Francesco Giavazzi – who have dealt with the Portuguese case in their recent work.

The several MIT missions of the mid-1970s were all organized by Richard Eckaus. He brought to Portugal a group of economists who were then or who would become famous around the world, including: Richard Eckaus, Robert Solow, Rudy Dornbusch, Peter Diamond, Cary Brown, Lance Taylor, Paul Krugman, Jeffrey Frankel, Keneth Rogoff, Jeremy Bulow, Miguel Beleza, David Germany and Raymond Hill.

I was the most direct beneficiary of the MIT missions and I am therefore in a good position to say that the economic advice of those missions was highly instrumental in the formulation of economic policy during the years from 1975 to 1977. It would have been even more useful if a larger share of the MIT recommendations had been followed more closely.

This is neither the place nor the occasion to summarize those recommendations. However, I should mention the one which in my view was the most important of them all. This was the introduction of the crawling peg for the exchange rate, with pre-announced targets. That measure was proposed by Rudy Dornbusch, and its results were spectacular. The crawling peg system contributed more than any other factor to the correction of current account deficit, although other measures, including the adjustments in interest rate and the introduction of credit ceilings, also had a significant effect. The crawling peg helped to improve the competitiveness of tradable goods, stimulate economic growth, and reduce the unemployment rate. It created some resistance to the reduction of inflation, but at that time the reduction of inflation to very low levels was not a priority when compared with the other goals of external equilibrium, growth and employment.

I am very happy that the President of the Republic, Prof. Cavaco Silva, who as a distinguished economist is in a good position to evaluate the work of the MIT missions, is to bestow the *Grã-Cruz da Ordem do Infante* upon Professors Eckaus and Solow, and I offer my most sincere congratulations to both of them.

I am also very happy that we can now count on a new wave of MIT professors, and their valuable opinions on the policies required to confront the present economic difficulties. Professor Giavazzi, who worked at MIT and is now Professor at Bocconi University in Italy, produced a joint paper with Prof. Blanchard on balance of payments problems of euro area countries, with a special reference to Portugal, and we look forward to his comments in this Conference. Professor Olivier Blanchard has looked at the case of Portugal in several contributions of his research, in which he has studied several features of our labor market and dealt with problems of the competitiveness of our tradable goods sector and our balance of payments.

In this Conference we will also have the contributions of several Portuguese economists who are well known and highly regarded in this country. I thank all of them for having accepted our invitation to present papers and add comments.

The MIT missions of 1975-78 came to Portugal at a time when our economy was in serious trouble. The present Conference takes place at a time when the troubles are even more serious. Nevertheless, the two situations are very different from each other. The crisis that began in 1974 had its origins in the simultaneous occurrence of three shocks:

- the first oil price shock
- the shocks caused by the revolutionary troubles
- and the decolonization shock.

As a result of these shocks:

- real GDP fell by 4.4 percent in 1975
- the rate of inflation rose from 10 percent in 1973 to more than 20 percent in 1977, 1978 and 1979;
- the rate of unemployment climbed from less than 3 percent in 1973 to 8 percent in 1978;
- real wages rose more than 30 percent in the two-year period of 1974-75;
- the real unit costs of labor in relation to those of the other 14 countries that formed the European Union before the last enlargement rose by 26 percent from 1973 to 1975;
- the share of exports of Portuguese goods and services in their respective markets fell by one third between 1973 and 1976;
- and the balance on current account transactions with the rest of the world eroded from a surplus of 2 percent in 1973 to a deficit of 7.4 percent in 1976.

The crisis revealed in these figures, was deep but it was short lived, and by 1978 it had practically disappeared:

- The level of real GDP was already 12 percent above the level of 1973 (the last year before the crisis);
- unemployment had risen to 8 percent of the labor force due to the arrival of hundreds of thousands of workers from the former colonies – but employment was growing rapidly and despite this massive immigration, the unemployment rate was starting to fall;
- inflation stood at around 20 percent, but that level was accepted as the price to pay for reaching the goals of external equilibrium, faster growth and lower unemployment;
- the excessive and unsustainable increase in real wages in 1974 had been partially corrected and the level of real unit labor costs in relation to the 14 other countries of the former EU had fallen by about 11 percent since 1975;

- Portugal was regaining a large proportion of the export market shares that had been lost from 1974 to 1976, and the improvement continued in the following two years of 1979 and 1980;
- the deficit in the current account had fallen from 7.4 percent of GDP in 1976 to 4 percent in 1978, and disappeared almost completely in 1979.

The rapid and substantial improvement in the Portuguese economic situation revealed in these figures is explained by two factors:

- the end of the revolutionary troubles, which translated into political stabilization and the strengthening of democracy from early 1976 on;
- the positive economic policy measures that were implemented, many of them on the basis of the advice received from the MIT missions.

The current crisis is more serious and more difficult to correct than that of 1974-75. It has already lasted for a longer period and it is likely to persist for several years into the future. It will also be much more difficult to solve, because of the nature of the shocks that caused it and because of the constraints and obstacles that we face now in the choice and implementation of adjustment policies.

The current crisis is due in part to adverse external shocks:

- better access of the Eastern European exporting countries, China and other emerging economies to the markets of the European Union, on which Portuguese exports are concentrated;
- the recent increases in oil prices, which have affected Portugal more than most other European countries, because our country is more dependent on imported energy.

However, the crisis also results from the type of response made by Portuguese economic agents to the conditions and constraints resulting from Portugal's participation in the EMU:

- the substantial decline in interest rates led to an extremely rapid accumulation of debts by households, enterprises and the government, which left apparently small margins for further increases in indebtedness. The consequence was that the growth of domestic demand has been constrained since 2001 and may be even more severely restricted in the coming years;
- at the same time, the behavior of prices and wages has not been adequately adapted to the constraints of the Monetary Union. It

has been marked by rigidities that in the past were avoided or compensated through exchange rate devaluations and comparatively high inflation rates.

The seriousness of the crisis is clearly revealed by a few statistics:

- the average annual growth rate of GDP in the 5-year period from 2001 to 2006 was only 0.5 percent. This rate is the lowest in any period of the same length since World War II and is the lowest of all the 25 members of the European Union over the last 5 years;
- the unemployment rate rose from 4 percent in 2001 to around 7.5 percent at present. Although this last rate is still below the average of the European Union, one must take into account that the productivity per worker increased at an average rate of only 0.3 percent from 2001 to 2006 against an average of 1.3 percent for the entire EU-25. Apparently, unemployment did not increase more because of labor hoarding and because many of the jobs that were created were characterized by low labor-productivity;
- a third indicator of the seriousness of the current economic situation is provided by the size of the deficits of the current account in the balance of payments. In recent years those deficits have been on the order of 8 percent to almost 10 percent of GDP, despite the very slow growth of domestic demand. Their main cause has been the disappointing performance of the international competitiveness of the tradable goods sector. The shares of Portuguese goods and services in their main markets have fallen continuously since 1990: 15 percent since then until 2000, and an additional 10 percent from 2000 until 2006. The growth of import penetration of foreign goods and services in the Portuguese domestic market is also an important sign of disappointing competitiveness.

It is quite clear that in order to return to more satisfactory levels of GDP growth and lower levels of unemployment we cannot rely on the stimulation of domestic demand, because it would lead to even higher external deficits, and as a consequence, would very quickly absorb the margin that may still be available for additional indebtedness of households, enterprises and the government.

There is widespread agreement that the economic recovery in the medium run must be based on improved international competitiveness of the tradable goods sector. The poor performance of competitiveness is explained primarily by two major factors:

- the external shocks mentioned above

- development in costs and prices, within the constraints imposed by the European Monetary Union.

The response to the shocks caused by Eastern European countries, China and other emerging economies must come from the transformation of the Portuguese productive structure, away from low technology industries, whose competitive advantage lies in low wages, and into industries in which quality, product differentiation and transport costs are important factors of competitive advantage. We cannot count on market forces alone to produce the required structural transformations. Policy measures must certainly play an important role in achieving such transformations. The government is engaged in promoting vocational training, research and development, innovation and entrepreneurship, and in improving the business environment. The government is also redirecting subsidies to new projects in the tradable goods sector that look promising from the point of view of future economic growth. I hope that the results to be achieved on the basis of these measures will be more satisfactory than those of similar experiences in the past. In any case, the transformation in the productive structures that we need will take time and their benefits will appear only gradually.

The second factor in the disappointing competitiveness is the performance of costs and prices:

- in spite of its very low growth rate of GDP, Portuguese inflation exceeded and continues to exceed, the average of the euro area, although now by a narrower margin;
- real wages continue to increase despite rising unemployment, contrary to what occurred in previous episodes of unemployment;
- because of these developments and the near stagnation in labor productivity, relative nominal unit labor costs in the entire economy in relation to the 14 other members of the European Union before the last enlargement continued to increase in recent years, rising by about 10 percent from 2000 to 2006, on top of an increase of more than 25 percent during the 1990s. Relative unit labor costs in manufacturing did not rise as much, but in spite of that their performance has been clearly unfavorable from the point of view of external competitiveness.

All of these indications suggest that there is too much rigidity in the prices of non-tradable goods and in wages. In order to improve international competitiveness of tradable goods in the short run it is essential:

- to achieve more intense competition in non-tradables. There are several key sectors in which competition is recognizably too weak;
- to analyze in depth the problem of rigidity in the labor market and to take appropriate measures. This is a controversial topic, even among economists, and it faces considerable political friction, but more discussions among qualified economists may in the end contribute to the introduction of the remedies that are needed;
- to seek better results in labor productivity in the near future;
- productivity improvements resulting from structured transformations appear only in the long run. It will be extremely difficult to realize such improvements within comparatively short periods. We cannot rely on the stimulation of domestic demand to reach the goal. We cannot stimulate exports or import substitution through exchange rate devaluations and subsidies, which in most cases are not allowed by the EC rules.

However, there may be some possibilities of stimulating labor productivity in the tradable goods sector without running afoul of the competition rules of the EEC. In addition, there are apparently important potential improvements in the production of non-tradables that could be implemented without excessively long delays. The problem is that the improvements would create problems in employment. Perhaps this should be combined with tighter controls on illegal immigration of non-qualified workers, which by itself is causing an annual growth rate of about 1 percent in the labor force. Exploring such possibilities might be useful, but it is not likely that they would produce important results in the short run or even in the medium term.

As Prof. Blanchard will show in his contribution, the failure to reduce the rigidity in the prices of non-tradables and in wages, and the failure to improve labor productivity very rapidly, will force the economy onto a path of competitive deflation that might lead to a disaster in terms of employment, growth, equity and social stability. The risks of such a disaster, and the policies needed to reduce them, will certainly be hot topics in the discussions of the Conference, and I am sure that they will be of great help to policy makers and the public in facing up to the tough challenges ahead.