**The Portuguese economy**

# A new sick man of Europe

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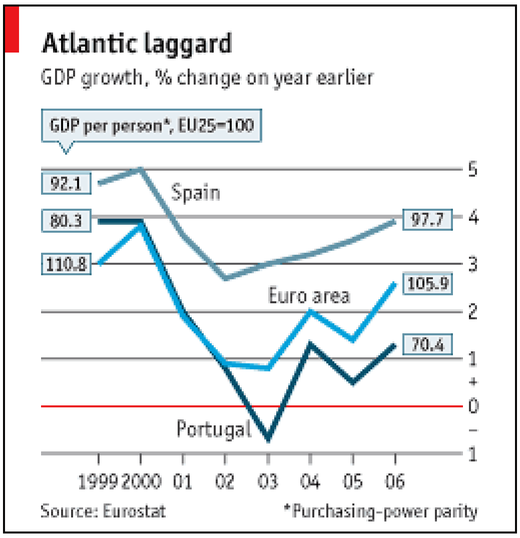
**Portugal comes bottom of the European economic growth league**

LOOK at any table of European economic data and Portugal stands out. GDP growth last year, at 1.3%, was the lowest not just in the European Union but in all of Europe. Since 2000 the Czech Republic, Greece, Malta and Slovenia have all overtaken Portugal in terms of GDP per head. And Portuguese GDP per head has fallen from just over 80% of the EU 25 average in 1999 to just over 70% last year.

Portugal was the first country threatened with sanctions by the European Commission for breaching the euro zone's stability and growth pact, which sets ceilings for euro members' budget deficits. The commission thinks Portugal's sin was to let public spending soar out of control, pushing the forecast deficit in early 2005 up to 6.8% of GDP, the highest in the euro zone. Ironically the commission is now headed by José Manuel Barroso, a former Portuguese prime minister who ought to shoulder some of the fiscal blame.

The government is still struggling to bring the deficit below the stability-pact ceiling of 3% of GDP. It also wants to shake off its image among economists of being a prime example of how not to behave when joining the euro. What this image neglects is that José Sócrates, the Socialist prime minister, has been getting to grips with reform in Portugal since he took office two years ago—with some success.




After commissioning a central-bank audit that revealed the alarming state of government finances, he broke an election pledge and raised value-added tax from 19% to 21%. He has attacked public-sector privileges by holding down pay, raising the minimum retirement age from 60 to 65 and cutting sick pay sharply. This year the focus is on streamlining the public administration, which costs more as a share of public spending than in any other euro zone country. Doctors, nurses, teachers, police and other public-sector workers have all taken to the streets in protest. But Mr Sócrates's tough approach is bearing fruit. The deficit fell to 3.9% of GDP in 2006, better than the initial target of 4.6%. At the same time, a jump in exports helped to lift growth above forecast.

Sharing the Iberian peninsula with the economic powerhouse of Spain, where growth has been above 3% in all but one of the past ten years, makes Portugal's performance look worse. In a poll last autumn, 28% of respondents said they would prefer to be part of a united Iberia under Spanish rule. Few Portuguese would really go that far, but they do ask why they are doing much worse than their neighbours.

There are several answers, say central-bank economists. Portugal has suffered more than Spain from higher oil prices. Its unit labour costs have risen sharply, whereas Germany's have fallen. Until recently, it has suffered a big drop in demand in its main export markets, especially Germany. Spain's economy has been buoyed by a construction boom fuelled by rising immigration. Renewed political instability has also taken a toll: on average governments in Lisbon have lasted just two years since the return of democracy in 1974.

But the biggest difference is that Spain reformed its public sector and disciplined its public finances before joining the euro, not afterwards. When interest rates fell and released a surge of growth in the late 1990s, Portugal responded with an expansionary fiscal policy instead of taming its deficit. This was Portugal's big missed opportunity: one that Mr Sócrates is now seeking, belatedly, to remedy.