Portugal's bailout and the crisis of the European Union from a capability perspective
Author(s): Leonardo Costa, Nuno Ornelas Martins and Francisca Guedes de Oliveira
Source: *Cambridge Journal of Economics*, Vol. 40, No. 6 (November 2016), pp. 1479-1496
Published by: Oxford University Press
Stable URL: https://www.jstor.org/stable/24915761

Cambridge Journal of Economics 2016, **40**, 1479–1496
doi:10.1093/cje/bew007
Advance Access publication 11 April 2016

Portugal's bailout and the crisis of the European Union from a capability perspective

Leonardo Costa, Nuno Ornelas Martins and Francisca Guedes de Oliveira*

The global financial crisis revealed the weaknesses of the EU integration process, in general, and of the Eurozone, in particular. The EU institutions responded to the crisis in an inadequate way, in the belief that government debt stabilisation had to be pursued before the economy recovers. This strategy was based on economic forecasting errors, exposing member-states to the speculative behaviour of financial markets, leading to the bailout of countries such as Portugal, and undermining the confidence in the single currency, in the European economy and in the European project itself. We analyse here the crisis of the European Union (EU) in light of the bailout of Portugal, and propose an alternative strategy for Portugal and the EU, drawing upon Amartya Sen's capability approach.

Key words: Portugal, European Union, Capability approach, Financial crisis, Bailout
JEL classifications: E02, F15, I30

1. Introduction

In this article we discuss the effects of the financial assistance programme in Portugal, drawing upon Amartya Sen's capability approach. We do so by scrutinizing the underlying philosophy that guided the programme, and its implications for the Portuguese economy and society, which have become manifest since Portugal requested financial assistance from the European Commission in April 2011.

The economic policies followed in the financial assistance programme have been designed by the *Troika*, constituted by the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF). The underlying philosophy behind the policy guidelines recommended by the *Troika* presupposes that the first step for economic recovery consists in the reduction of the public deficit, in order to stabilize the public debt. Once this first step is achieved, the second step consists in fostering economic growth through exports, where cost-competitiveness is achieved through lower wages. The reduction of wages in the public sector plays a

Manuscript received 19 March 2014; final version received 27 August 2015.
Address for correspondence: Nuno Ornelas Martins, Universidade Católica Portuguesa, Rua Diogo Botelho, 1327. 4169-005 Porto, Portugal; email: nmartins@porto.ucp.pt

*Universidade Católica Portuguesa - Católica Porto Business School (F.G.O., L.C. and N.O.M.); CEGE (L.C. and N.O.M.). The authors wish to thank Fernando Medina, for a lecture he gave at the Universidade Católica Portuguesa (Porto) on the financial crisis, and António Melo and the anonymous referees of this journal for useful suggestions.

central role in step one, while putting pressure on the wages of the private sector in the hope of achieving lower wages in the export sector in step two. The promotion of human well-being would come only at a later stage, once economic growth is restored. So the implied sequence of priorities to be followed under this strategy is 1) achieve a balanced government budget; 2) achieve economic growth through exports; and 3) wait for an improvement in human well-being as a result of economic growth. The transition to step two could be fast given the *Troika* belief on the supposed stimulating effects of confidence, by which cutting government spending would lead to renewed confidence and quick economic recovery, an idea supported by Alesina and Ardagna (2010). The transition to step three would require more time, in the belief that inequality will gradually disappear in the long run, as suggested by Kuznets' curve.

What is new in this strategy is not the strategy in itself, but rather its systematic application within Europe. The same strategy has been applied by the IMF throughout the world in developing countries, never with much success. The lack of success of this strategy has raised the criticism of various economists, from heterodox economists working in different economic traditions, to Memorial Nobel Prize winners like Amartya Sen, Joseph Stiglitz and Paul Krugman. Sen (1992, 1997, 1999), in particular, has pointed out that the expansion of human capabilities is not only a final goal, but also a means to economic performance, since education and health increase what is usually called human capital. Furthermore, Sen (1999) argues that it is easier to control public finances after the economy recovers, rather than before, a point also made by Stiglitz (2002, 2003).

Much of the empirical support for policies pursued by the EU and the IMF stemmed from the findings of Reinhart and Rogoff (2010), who reported that levels of public debt above 90% of the country's GDP lead to a sudden collapse of economic performance. As Herndon, Ash and Pollin (2014) have shown, there were errors in the estimates made by Reinhart and Rogoff (2010), and the negative effects of cutting the public deficit have also been severely underestimated—see Blanchard and Leigh (2013). In fact, the reduction of wages, and of spending in education and health, which has been recommended by the *Troika*, contributes to the increase of inequality in various dimensions, which in turn has devastating consequences not only for society, but also for the economy, due to the reduction of demand it causes, leading to a vicious circle—see Sen (1992), Martins (2011, 2013) and Stiglitz (2012).

Thus, the strategy followed by the *Troika* has serious limitations, due to an inadequate understanding of the nature of development processes. As we shall argue, there is no reason to postpone social policies aimed at fostering full employment, education, health and social equality to a later stage, as the *Troika* presupposes while forcing economic policies that have actually led to the deterioration of employment, health and education, and to an increase in inequality in various dimensions. Quite the contrary, social policies aimed at fostering full employment, education, health and social equality are essential for economic performance, which in turn is essential for the reduction of the public deficit, as Sen (1997, 1999) argues. So those social policies should not be postponed not only for ethical reasons, but also for motives connected to economic performance. The strategic sequence imposed by the *Troika* in the adjustment programme is the exact opposite of the one defended by Sen (1997, 1999), who also foresaw the problems faced by countries like Portugal when the common currency was implemented in the Eurozone, noting how the lack of autonomy at the level of monetary policy could bring difficulties in the future; that is, today.

In this article we address Portugal's bailout, drawing upon the integrated view of development processes provided by Sen's capability approach. The article unfolds as follows. After this introductory section, Section 2 describes the pathway of integration of Portugal in the EU, with globalisation, the unification of Germany, the Treaty of Maastricht, the Single European Market, the adoption of the Euro, the EU Eastern Enlargement and the Treaty of Lisbon, and how this pathway and its vicissitudes explain the request for financial assistance that Portugal made to the EC in April 2011. Section 3 describes the impact on the Portuguese economy and society of the bailout program and the reaction of the Portuguese government. Section 4 discusses alternatives for Portugal and for the EU. Finally, Section 5 summarizes the main results.

2. The European Union and Portugal's bailout

In this section we argue that the problem of Portugal at the eve of the financial crisis of 2007–2008 was one of current account imbalances and foreign debt, and not one of sovereign debt. The external imbalances of the country can be explained by its path of integration in the EU and by the changes that have taken place in the EU since the Maastricht Treaty of 1992. The sovereign debt problem appeared only in 2010, after the financial crisis. It was a consequence of the financial crisis and of the invitation made by the EC for member-states to bail out their banks and to provide fiscal stimulus to their real economies, alleviating the recession. The rescue of countries such as Portugal was a result of the increase of the sovereign debts of all member-states, the refusal of the EU institutions to see the Eurozone as a whole in the emergency, the absence of national capital controls and policy instruments (exchange rate, monetary and fiscal policies), the deteriorated international investment position, the rating agencies and the fact that the ECB did not intervene sooner, as it did more recently (and even then, concerned only with the public debt of countries that have accepted austerity without challenging it).

Portugal joined the European Economic Community (EEC) in 1986, and signed the Treaty of Maastricht and endorsed the Single European Market in 1992. The country was a founding member of the Euro (named as such in 1995, defined in 1999, and in circulation since 2002), supported the EU Eastern Enlargement, which began in 2004, endorsed the Treaty of Lisbon in 2007 and endured the EU's engagement with economic and financial globalisation. Those factors led to several consequences for Portugal in this period.

First, it led to a change in the productive structure of the country. In particular, it led to a decrease in the production of tradable goods (more exposed to international competition) relative to non-tradable goods (more protected from such competition) (Figure 1), and to the country's loss of external competitiveness, strengthening its net importer position. This is explained by the increased competition in the markets for goods and factors, European and global, the adoption of a strong Euro and the rise in the dollar price of the barrel of crude oil in the world market. As examples of increased competition, one need only note the EU Eastern Enlargement, the WTO entry of India and China, respectively in 1995 and 2001, the WTO Agriculture Agreement in 1995 and the expiration of the Multi-Fibre Agreement (MFA) at the WTO in late 2004. The strong Euro, in what concerns to the Portuguese economy, led to a monetary policy in the Eurozone which, following the German model, elected price stability as the top priority, in a context where there were several depreciations of the dollar.

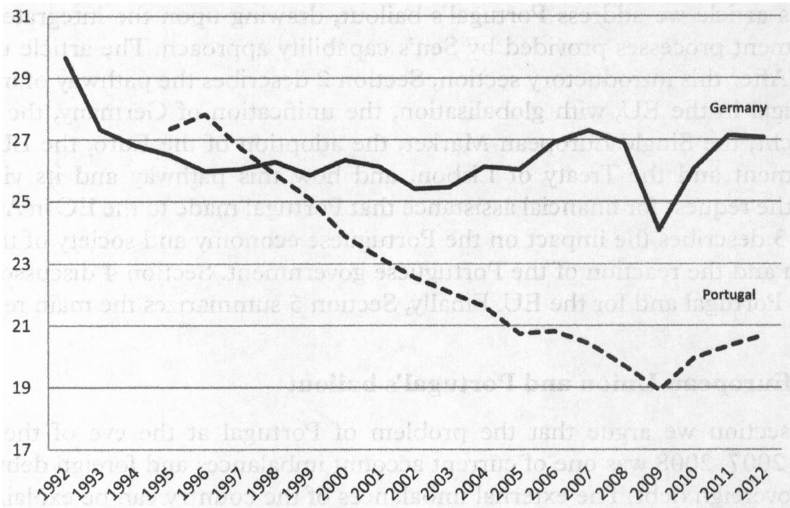

Fig. 1. Gross Value Added of tradable goods in % of total Gross Value Added: Germany and Portugal

Source: Built by the authors with Eurostat data. Tradable goods are assumed to be the ones produced in the primary sector and in the secondary sector (with the exception of construction).

The effect was to render exports for the rest of the world less competitive, leading also to increases in imports from the rest of the world. The rise in the dollar price of the barrel of crude oil in the world market had a negative impact in terms of trade of the Portuguese economy, given its high dependence on oil imports.

Second, there was an integration of domestic financial markets in its EU counterparts, within the framework of the European Monetary System (EMS), and of the EMS in the world financial markets. These implied low interest rates in the domestic markets, in relation to the history of the country and due to the influx of foreign capital, and a growing foreign debt, accelerating after the onset of the global economic crisis, strengthening the net debtor position of the country in international financial markets (Figure 2, see also the data presented by the Portuguese Government [2013, p. 28]).

Third, it meant the loss of the domestic control of exchange rate policy, of interest rates, of capital movements, of monetary policy in general and, to a large extent, of fiscal policy, due to the country's adoption of the Euro. This implied the absence of national macroeconomic instruments to face the sovereign debt crisis, when the EU institutions decided that each member-state of the Eurozone should face the financial markets alone, not allowing, for instance, the creation of Eurobonds—on which see Varoufakis and Holland (2011) and Galbraith, Holland and Varoufakis (2014).

Finally, it led to public policies at the EU and national levels which were unconcerned with Small and Medium Enterprises (SMEs), which dominate the productive structure of the country (see Bloom *et al.*, 2012).

This was the country's situation at the eve of the 2007–2008 financial crisis and of the Great Recession lived since then. An increasing specialization in non-tradable goods and an increasing dependence on external funding followed, in a context where the country did not have macroeconomic policy instruments at its disposal in order to counter the situation generated by such diverse factors as Maastricht and the Single

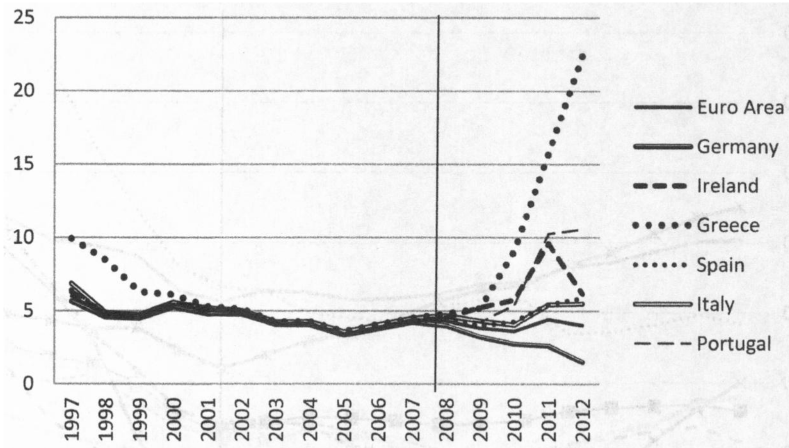

Fig. 2. Long run interest rates of sovereign debts of a few member-states of the Eurozone, 1997 to 2012

Source: Built by the authors with Eurostat data. Interest rates correspond to the `MEU convergence criterion series' of the Treaty of Maastricht. Data are based on the yields of governments' bonds in the secondary market, with a residual maturity of 10 years.

European Market; the adoption of a strong Euro; globalisation and the EU Eastern Enlargement; the Treaty of Lisbon; the rising price of oil; a productive structure dominated by SMEs and public policy not oriented to this type of firms; a backdrop of the global economy rather unfavourable (in the past decade and a half); and a target annual deficit (not corrected by the business cycle) of 3%, imposed by the Stability and Growth Pact (SGP) of the EU, a target that the country had difficulties to comply with (see also the data presented by the Portuguese Government [2013, p. 27]).

Thus, as the 2007–2008 financial crisis emerged, the main problem of the country was foreign debt and not government debt (Casaca and Artamendi, 2014), despite the organizational weaknesses of the Portuguese State (see Costa and Osório, 2013; IMF, 2013; OECD, 2013). In 2007, the government debt to GDP was slightly higher in Portugal than it was in Germany. It is after 2007, with the financial crisis, that the sovereign debts soar, in Germany, in Portugal, and in all member-states of the EU (Figure 3), as explained below.

The EU structural funds, whose function has been to support and/or compensate the member-states with weaker economies of the EU in their convergence process, were not able to reverse the progressive specialization of the country in non-tradable goods and its growing foreign debt (see Ribeiro, 2009; Mateus *et al.*, 2013). The latter turned out to be unsustainable in the long term, for Portugal and other member-states of the Eurozone in a similar situation. The policies undertaken by the EU lacked reflected revision. Despite having progressed a lot after the April revolution of 1974, and the entry into what was then the European Economic Community (EEC), in 1986, Portugal has a level of development, a human capital stock, organizational skills, and an economy which are not comparable with the wealthier member-states of the EU. This is important because management practices are strongly linked to levels of development (Bloom *et al.*, 2012) as well as to the structure of an economy and whether it has a business fabric made of advanced or modern industry, which Portugal does not have.

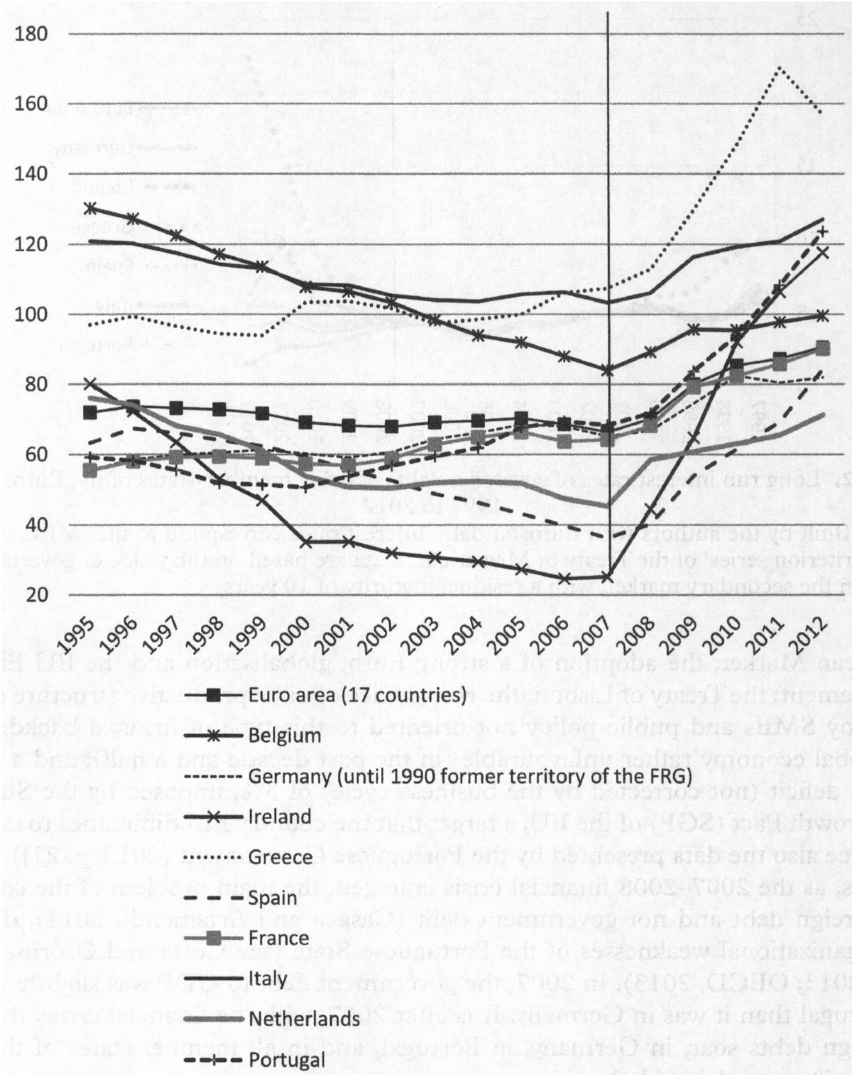

Fig. 3. Government consolidated gross debt in % of GDP of a few member-states of the Eurozone, 1995 to 2012

Source: Built by the authors with Eurostat data.

The background to the financial crisis that hit the EU in 2007–2008 was the fallout from the subprime crisis in which major European banks were holding non-performing or worthless debt that had been classified AAA by rating agencies. They thereby lost liquidity to fund, for instance, the weaker economies of the EU, and lost confidence in each other with an ensuing credit crunch. National governments have been called by the EU to respond to the crisis with bailouts for banks and by ensuring a Europe-wide fiscal stimulus. All member-states of the EU increased their sovereign debt, converting private debts into public debt (Figure 5). With the Greek crisis and the German position on it, those with weaker economies became a target for speculation and their debt was downgraded by the rating agencies. The interest rates on these debts soared and the financial markets of the Eurozone became segmented (Figure 2, De Grauwe and Ji, 2013b; Casaca and Artamendi, 2014).

Instead of helping the weaker member-States of the Eurozone at this moment of emergency through Eurobonds, capital controls or other alternative instruments that would show evidence of a united front in the Eurozone, the EU institutions responded to the challenge with austerity, saying that each country was a separate case, allowing the segmentation of financial markets within the Eurozone, feeding speculation and leading to the bailout of a few member-states. The EU institutions knew that those member-states no longer had instruments of economic policy such as having their own currency, exchange rate policy, monetary policy, capital controls or fiscal autonomy. Under the pressure of Germany and a few other member-states, the EC, the ECB and the IMF have been trying to take the Eurozone as a simple fixed exchange rate regime, in which the adoption of a single currency only serves to materialize the irrevocable fixing of exchange rates—the worst of both worlds. This led to a crisis in the Eurozone which endangers not only the Euro but also the EU itself—see Casaca and Artamendi (2014) for a recent discussion of the topic. Eurostat (2016) data on unemployment ranging from 2000 to 2015 illustrates how ineptly the EU is dealing with the crisis when compared with the USA and Japan.

If the EU institutions had intervened in the financial markets, the bailout of Portugal would have been, most likely, unnecessary, as the announcement of outright monetary transactions and the more recent quantitative easing policy of the ECB demonstrates. Instead, they have chosen to adopt a discourse in which they pointed to government failure and sovereign debt as the main problems of the Eurozone's weaker economies and have decided to ask the help of the IMF in order to rescue, when necessary, those member-states within the context set by the *Troïka*. The financial markets (in particular, and in the European case, the banks), whose failures and speculative behaviour (sometimes criminal) are behind the world financial crisis and the Great Recession were, in contrast, left mostly untouched. So moral hazard was not a problem for the EU institutions in the bailout of banks, but it was a problem in the bailout of the cohesion countries, the PIIGS or GIPSI member-states of the EU, as the countries with economies under pressure (Greece, Ireland, Portugal, Spain and Italy) have started to be called. A rationale for the position lies in the fact that member-states were responsible for the bailout of their own banks at the time.

The discourse mentioned above, shifting the focus from the external imbalances of the EU to the sovereign debts of cohesion countries, is connected to the need of ensuring the legitimacy of the policies followed (the pursuit of policies that apparently protect the national interests of the wealthy member-states of the EU, implying a transfer of income and wealth from the less developed to the more developed member-states, must be widely accepted and regarded as legitimate). External imbalances between the stronger and the weaker economies of the Eurozone were expected by key decision-makers, or economists who had influence on key decision-makers. Specifically mentioning Portugal and Greece, Blanchard and Giavazzi argued that

> The fact that Portugal and Greece are each members of both the European Union and of the Euro area, and, in each case, the poorest members, suggests a natural explanation for these current account deficits. They are exactly what theory suggests can and should happen when countries become more closely linked in goods and financial markets. To the extent that they are the countries with higher rates of return, poor countries should see an increase in investment. And to the extent that they are the countries with higher growth prospects, they should also see a

decrease in saving. Thus, on both counts, poor countries should run larger current account deficits. Symmetrically, richer countries should run larger current account surpluses. (Blanchard and Giavazzi 2002, p. 148)

Thus, it was expected for the poor countries of the Eurozone to see an increase on their current account deficits and, symmetrically, for the rich countries of the Eurozone to see a decrease on those deficits. That is, the increase of the Current Account deficit of Portugal, which is behind the excessive external indebtedness of the country, was, according to Blanchard and Giavazzi (2002), the natural, expected, outcome to a poor economy in the context of the Eurozone. Still, according to Blanchard and Giavazzi:

For countries such as Greece and Portugal, economic integration has had three main dimensions: the Single European Market, which mostly affected the product market; the integration of financial markets within the European Union; and finally, monetary union, with the adoption of the Euro in the late 1990s. All three channels have clearly worked in the direction of potentially widening the current account deficits of these countries. (Blanchard and Giavazzi 2002, p. 152; see also Casaca and Artamendi [2014] for a recent discussion of the topic)

To the above channels one may add the EU Eastern Enlargement and the deepening of globalisation. Figure 4 illustrates the average situation in the current account of some member-states in the period 1999–2007. The division between poor and rich countries of the EU, between winners and losers of the integration process, is notorious.

In recent EU framework programs, particularly with the Eastern Enlargement, some member-states have become net contributors of the EU budget and have seen their effective contributions increase. Figure 5 illustrates the situation of the average net transfers as a percentage of GDP in a few member-states, in the period 2000–2011. Negative values illustrate situations of member-states that are net payers of the EU budget; that is, they pay more for the EU budget than they receive, and vice versa. From Figure 5 we can realize that the annual average net contribution of net payers does not exceed 0.5% of their GDP in the period under analysis (already taking into account the EU Eastern Enlargement and the financial crisis). Nonetheless, there is a fiscal discomfort in some of the net-payer member-states, namely in Germany. The unequal distribution of wealth in those member-states may explain, at least in part, the discomfort (see Figure 6 and De Grauwe and Ji [2013a] on this topic). The financial crisis turned out to be an opportunity for those member-states to question their net contributions to the EU budget.

In this section we argued that the main problem of the Portuguese economy before the financial crisis and the country bailout was one of external debt and not one of government debt. We now move on to describing the consequences of the Portuguese bailout programme and the reactions of the Portuguese government.

3. What about Portugal?

The *Troika* official intervention ended in May 2014. During the intervention, the country experienced a process of economic and social decline without precedent. OECD (2014) data on Portugal illustrates the *Troika* intervention in the country.

The export sector performance has been strong. The stronger performance started before the bailout programme and has continued during the bailout period and after, as a response to the fall in total internal demand and to the more recent fall in oil prices and the interventions of the ECB. Nonetheless, the current account balance

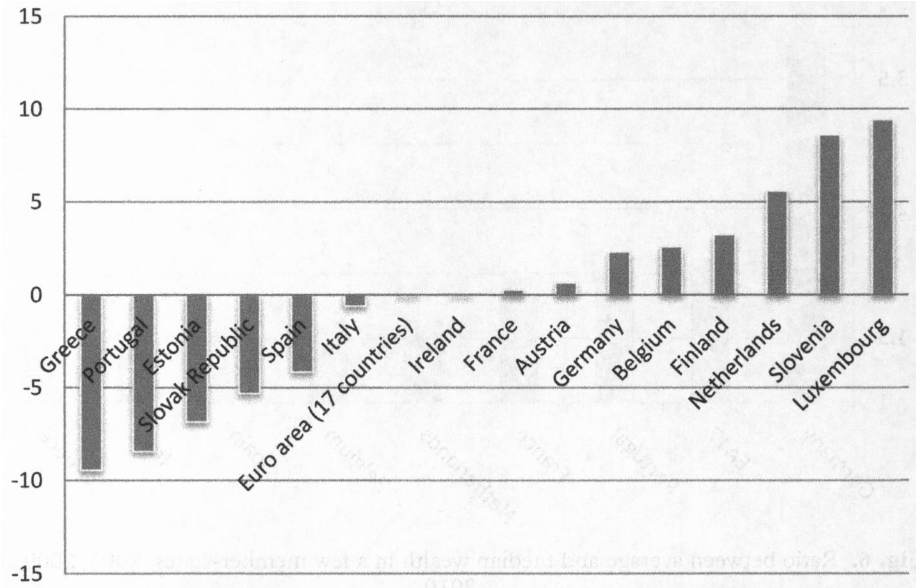

Fig. 4. Current account balance in % of GDP of a few member-states of the Eurozone, average 1999–2007

Source: Built by the authors with Eurostat data. Adapted from Krugman (2012), 'European Crisis Realities', The Conscience of a Liberal, Blog, *New York Times*, 25 February 2012

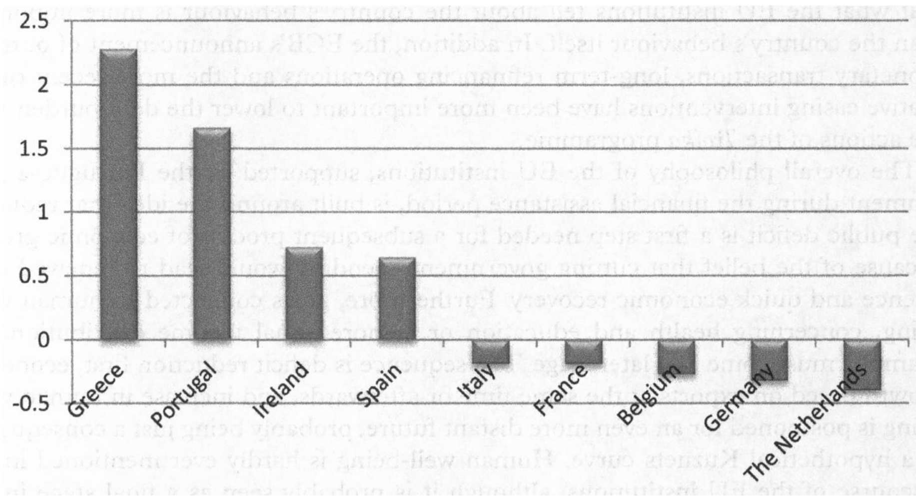

Fig. 5. EU budget net payments of a few member-states in % GDP, average 2000–2011

Source: Built by the authors with data available in http://www.eu-oplysningen.dk/euo_en/spsv/all/79/. A negative number means the member-state is a net payer of the EU and vice versa.

equilibrium has been done mainly by the reduction in imports (see OECD, 2014, on these).

During the financial assistance period, the Portuguese government accepted the *Troika* programme, and in fact argued that the country should go even further in the direction advised by the *Troika* than it was required to. We can think that it did so as a way to recover the confidence of the financial markets, given the isolation the country

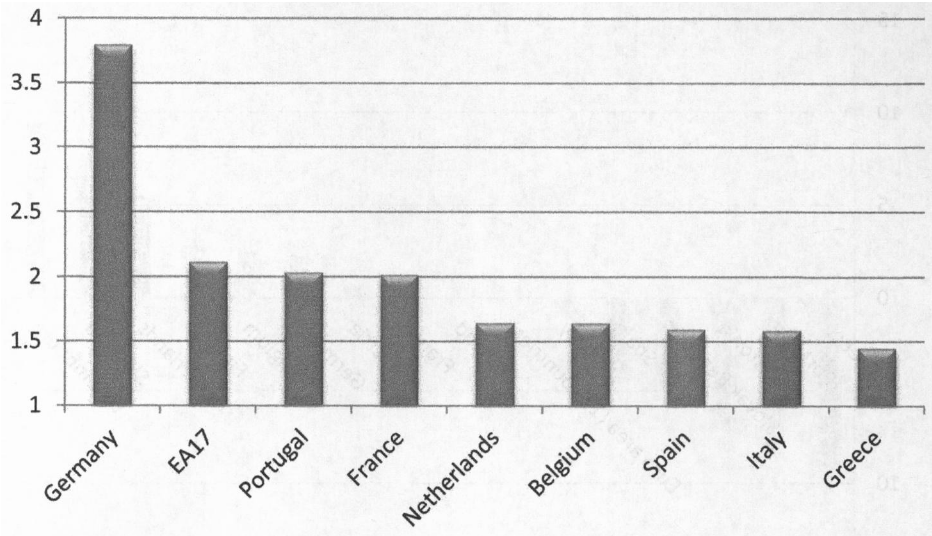

Fig. 6. Ratio between average and median wealth in a few member-states, 2008, 2009 and 2010

Source: ECB, data cited by De Grauwe and Ji (2013a). Years: Spain 2008, Greece 2009, Netherlands 2009, other countries and EA17 2010.

was set to in these markets by the EU institutions. However, it is everyday evidence that what the EU institutions tell about the country's behaviour is more important than the country's behaviour itself. In addition, the ECB's announcement of outright monetary transactions, long-term refinancing operations and the more recent quantitative easing interventions have been more important to lower the debt burden than the actions of the *Troika* programme.

The overall philosophy of the EU institutions, supported by the Portuguese government during the financial assistance period, is built around the idea that reducing the public deficit is a first step needed for a subsequent process of economic growth because of the belief that cutting government spending would lead to renewed confidence and quick economic recovery. Furthermore, goals connected to human well-being, concerning health and education or a more equal income distribution, for example, must come at a later stage. The sequence is deficit reduction first, economic growth based on exports at the same time or afterwards, and increase in human well-being is postponed for an even more distant future, probably being just a consequence of a hypothetical Kuznets curve. Human well-being is hardly ever mentioned in the discourse of the EU institutions, although it is probably seen as a final stage in the 'finance-economy-welfare' sequence. In fact, the underlying idea behind austerity policies is that human well-being must be reduced temporarily (thus austerity policies lead to cuts in fields such as education and health, to the increase of unemployment and to the reduction of labour income) in order to reduce government debt.

Amartya Sen (1999, p. 140) notes that reducing the public deficit before the economy is fully recovered is a misguided strategy, which he calls 'anti-deficit radicalism', since it does not take into account that economic performance is essential for deficit reduction and debt stabilization. For Sen (1999), the more appropriate route consists in reducing the public deficit *after* the economy starts its recovery, which in turn requires policies that are the exact opposite of the austerity policies. Sen (1999) also notes that many development goals concerning issues such as health and education are not merely goals to be achieved after economic recovery is fostered, but also instrumental to achieving recovery, since health and education also contribute to the formation of human capabilities that increase not only human well-being, but also what is often called human 'capital', and productivity. Thus, the strategic sequence 'finance-economy-welfare' implied in austerity policies fails to take into account the interconnections between various dimensions of development processes. Financial outcomes, economic performance and human welfare cannot be seen separately and sequentially, much less if the sequential order is the one imposed by the structural adjustment programme.

Effectively, Sen's (1999) perspective actually suggests that if financial outcomes, economic performance and human welfare were to be addressed sequentially, the more intelligent strategy is not the 'finance-economy-welfare' sequence in practice presupposed by the adjustment programme, but rather a 'welfare-economy-finance' sequence; that is, the reverse sequence, since the expansion of human capabilities (which increases human well-being in a direct way) also leads to a superior economic performance, which in turn provides the conditions for the solution of financial problems.

Sen's perspective on Europe stems from his capability approach (Sen, 1985). For Sen, human well-being depends upon the achievement of human functionings we have reason to value, where a functioning is what a person is or does. Human capabilities are potential functionings, and human development is the process of the expansion of human capabilities. Sen (1999) notes that human capabilities are not just an ethical goal, but also a means for further development—see Martins (2006, 2013) for a discussion of capabilities as causal powers for social transformation. The underlying strategy stemming from Sen's capability approach is that the expansion of human capabilities should not be postponed to a final stage, since it is also a means for improving economic performance, which in turn is essential for achieving financial outcomes. This is why Sen's capability approach leads to a strategy which is radically different from (or indeed opposite to) the one adopted in the adjustment programme imposed by the *Troika*.

The adoption of an alternative strategy would clearly have important implications, which must be carefully scrutinised through political discussion. Democratic discussion is another central aspect of development processes, which is not only constitutive of human well-being, but also instrumental to the success of the strategy adopted, as Sen (1999) explains. And as Sen (2011) also notes, the European strategy towards the crisis has contributed much to undermine the European democratic tradition, amongst many other European social values.

Sen (1997, 1999, 2011) has been criticising the European institutions for a long time for their lack of attention to unemployment and inequality, while also pointing out that the adoption of a common currency, the Euro, reduces significantly the policy options of member-states. Sen (1997) notes that unemployment leads to a loss of current output (in comparison to the output that would be achieved under full employment); a fiscal burden (due to the need of income transfers to the unemployed); loss of freedom; social exclusion; loss of skills; psychological harm; ill health; higher mortality; loss of human relations and family life; and an increase in inequality, amongst many other problems. These factors pose severe constraints not only to social progress, but also to economic performance, which are grossly neglected by the *Troika* programme due to its exclusive focus on public deficit reduction in the first stage of its overall strategy.

The idea that governments cannot run deficits in times of recession follows from a strategy which does not take into account the role of human capabilities and income distribution in economic performance. In fact, the recent findings by Herndon, Ash and Pollin (2014) show that the empirical support for the *Troika* strategy provided by Reinhart and Rogoff (2010) contains basic calculation errors which led to the wrong belief that economic growth is incompatible with levels of public debt above 90% of the country's GDP. Herndon, Ash and Pollin (2014) show that what the empirical data used by Reinhart and Rogoff (2010) actually tells us is that it is possible to pursue strategies focused on economic performance at an earlier stage, as Sen (1999) recommends.

The idea that cutting public spending does not have a strong negative impact on the economy in the present context faced by the Eurozone has also been challenged recently (Blanchard and Leigh, 2013; IMF, 2012; Romer, 2011). The recessive effects of public spending cuts occurred, and these cuts also paralysed the government's administration and public investment. The strategy followed included an increase in taxes, but there is no room to charge more taxes in Portugal, as these are counterproductive even in what concerns tax revenue (see Guedes de Oliveira and Costa, 2015, on VAT). In addition, with the uncertainty about the future created by the adjustment programme, private consumption and investment were reduced during the adjustment programme. The ECB's more recent commitment to improving the Portuguese financial situation can perhaps explain the subsequent recovery of GDP, mainly driven by internal demand (consumption).

The permanent effects for Portugal that can result from the emigration of its younger and more qualified generation are disastrous. Nothing guarantees that the young Portuguese will return. Many will not. Adding to this the brutal decrease in birth rate, the accelerated aging of the Portuguese population is thus inevitable. The outcome has been to reduce the amount of pensions paid, and to increase the retirement age, further contributing to youth unemployment, and to a deterioration of human capabilities, with a direct effect on human well-being, and an indirect effect which comes through the reduction of productivity that follows from this deterioration.

Portugal is witnessing (as is Greece) the accelerated destruction of its productive capacity, after years of deindustrialization (Amaral, 2013), and the destruction of its social cohesion. The destruction of social cohesion has serious effects not only on human capabilities, but also on the increase of inequality which, in turn, is a crucial factor in reducing effective demand in a context of crisis, leading to a vicious circle—see Martins (2011) and Stiglitz (2012) on the connections between inequality and the crisis, and see also Martins (2013) on how Sen's capability approach can shed light on those problems too. In the next section, we discuss possible alternative strategies drawing upon Sen's capability approach.

4. What is to be done

A different strategy is clearly needed, which takes into account the complex interconnections between financial outcomes, economic performance, and social progress, while realising that these aspects cannot be addressed separately and sequentially, as presupposed by the *Troika*. Rather, they are deeply interconnected and must be seen in an integrated way, within an approach that takes the expansion of human capabilities both as a final goal, and also as a means to economic performance and financial consolidation, as Sen (1999) argues. Or, if financial outcomes, economic performance and social progress are addressed sequentially, the more intelligent sequence would be exactly the opposite one to that adopted by the *Troika*, as Sen's capability approach suggests.

More than contributing to adjust the production structure of the country, the adjustment programme has undermined it, which again shows that addressing financial outcomes before improving economic performance is an inadequate strategy, as Sen (1999) notes. Since adjustment programmes have been applied to various countries, political prospects of change are more favourable if they are coordinated with other countries. Of course, the countries that have been in adjustment programmes faced different circumstances, and the adjustment programmes were supposedly designed taking into account those specificities. But the overall philosophy underpinning the activity of the European institutions in these various cases has been the same, driven by the idea that reducing the public deficit is the first step for a subsequent process of economic growth based on exports.

The various countries facing adjustment programmes, or more subtle interventions by the European Central Bank in secondary markets, are all victims of what Sen (1999, p. 140) calls 'anti-deficit radicalism'. All the countries facing problems in virtue of this can benefit from a more articulated attitude against 'anti-deficit radicalism'. In fact, the political weight of various countries facing this problem is very different from the political weight of one country alone. In order to shed some light on possible alternative policies, we draw upon Sen's instrumental freedoms next in order to discuss an alternative strategy. These instrumental freedoms include political freedoms, economic facilities, social opportunities, transparency guarantees and protective security—see Sen (1999) and Martins (2006, 2013) for a theoretical discussion.

4.1 Political freedoms

A political discussion is needed in the EU on what has been its course since the unification of Germany, taking into account the Treaty of Maastricht and the Single European Market, the Euro and the EU Eastern Enlargement, the Treaty of Lisbon and globalisation, especially financial globalisation. In particular, one must reassess 1) the systematic confusion between market failures and market efficiency, namely in what concerns the financial markets; 2) the subordination of the EU to the whims of the financial markets; 3) the deregulation of markets, namely the deregulation of financial markets; 4) the political dismissal of nation-states or networks of nation-states such as the EU from market regulation, namely financial markets regulation; 5) the exclusion of national democratic institutions from dialogue on alternatives to austerity; and 6) the absence of democratic governance and regulation of the global economy, at the European and world level.

A clear distinction is also needed between the global financial crisis and the crisis of competitiveness of some EU member-states such as Portugal. The competitiveness crisis of Portugal and other member-states of the EU is prior to the financial crisis and has specific causes. The analysis of the evolution of the productive structure of these countries, since Maastricht and the Single European Market, taking into account the single currency and the EU Eastern Enlargement, the Treaty of Lisbon and globalisation, has to be undertaken, so that democratic voting procedures can be undertaken with more accurate information.

A political discussion of the position of the EU with respect to the need of regulating the international financial markets and to prevent new global financial crises, similar to the current one, as well as concrete policy measures to address this issue must also be discussed—see also Holland (2014) for an important discussion of the contemporary problems in European policy.

4.2 Economic facilities

The changes necessary to the proper economic functioning of the Eurozone need also to be discussed (see Casaca and Artamendi, 2014, proposal on reform of the Euro). These changes should imply that the EU institutions 1) assume the Eurozone as a complete monetary union, with a banking union and the ECB as lender of last resort; 2) develop solidarity mechanisms (Eurobonds, capital controls and Tobin tax, amongst others), to tackle speculation in financial markets; 3) extend the mission of the ECB, as it happens with the US Federal Reserve, setting employment as one of the missions; 4) assume that the Eurozone is not, nor will it be anytime soon, an optimal monetary zone, as it is subject to asymmetric shocks and there are limits to factor mobility within it; 5) call to themselves the pursuit of a more active countercyclical fiscal policy, allowing it to cope with asymmetric shocks affecting the Eurozone, which requires a clear definition of what are the competencies of the EU and of the member-states, in the context of the globalisation we live in, without jeopardizing the European principle of subsidiarity; and 6) as recently supported by De Grauwe (2013), not only the ECB would be lender of last resort, as the Eurozone would ensure minimum social standards for all citizens of its member-states.

The country needs also to renegotiate its foreign debt. The quantitative easing of the ECB has helped alleviate the service of the debt. Nonetheless, without renegotiation, the chances for increasing the country's private and public investment are narrow. The EU institutions should also address the concrete possibilities of a country like Portugal to remain in the Eurozone, without going into chronic loss of competitiveness, even taking into account the changes in the Eurozone we propose. The Euro has proved to be a currency too strong for the Portuguese economy, and it is unrealistic to think that the country will be able to obey the same rules as the strongest economies in the Eurozone.

A modern type of a Marshall Plan for EU competitiveness, employment and sustainable development is necessary in order to mitigate the effects of the financial crisis on the real economy and on employment in the EU, to help the competiveness reconstruction of member-states in difficulties, such as Portugal, to support the environmental strategy of the EU, and reduce inequality across groups and territories of the EU. The plan could develop from the Juncker Plan, but it needs to rely more on public investment in order to increase aggregate demand, and be more oriented to innovation which is needed as a supply-side factor of progress.

4.3 Social opportunities

The role of supply-side factors and demand-side factors can be seen quite clearly not only at the level of economic facilities, but also in what social opportunities are concerned. As Sen (1999) notes, investment in education and health is an example of an investment which has a direct effect on the increase of human well-being, but also an instrumental effect through the increase in productivity it brings, which works through supply-side factors connected to the expansion of human capabilities. Furthermore, other measures aimed at ensuring greater equality, such as a more equal distribution of income, also improve economic performance through demand-side factors, since they transfer more income to those with a higher marginal propensity to consume, who are typically those with lower wages—see Martins (2011, 2013) for a more detailed discussion drawing upon the analysis of Michal Kalecki (1971) and John Maynard Keynes (1936). Income transferred to those with lower incomes has a stimulating effect on the economy, especially in a context where savings are not reinvested due to the financial and economic crisis, and thus the recapitalisation of the financial sector does not have a significant impact on aggregate demand, since the money transferred to the financial sector (through savings or quantitative easing) does not reach the real economy during a crisis.

Cuts in the wages of those with less income, and in the provision of education and healthcare services, should therefore be avoided, since they have negative effects not only on human well-being, but also on economic performance, which as noted above work through supply-side factors which have been identified in Sen's capability approach, and demand-side factors which have been identified in the post-Keynesian literature—see Martins (2009, 2013) on the need for an integrated view of supply-side and demand-side factors in the study of social and economic inequality, while drawing upon a capability perspective.

4.4 *Transparency guarantees*

There is also the need of an analysis of income transfers between member-states via EU funds (all funds, including the agricultural funds) and via the Single European Market, from Maastricht to date, clarifying which member-states are actually net payers of the EU. A part of the structural funds received by the beneficiary member-states have been used to purchase equipment to member-state net payers of the EU budget. Income transfers between member-states also exist via the Single European Market, not just through the Community budget. All benefits and costs of the various member-states should be accounted for and explained. A situation that is beyond the 'acquired rights' of each member-state should lead to considering a possible reassignment of funds.

The assessment of the EU administrative bodies and its public accountability before EU political institutions should also be considered, most notably in the case of the European Commission, European Council and European Parliament. Member-states should have the right of public contradictory before these institutions. There have been a few auditions by the European Parliament concerning the *Troika* and the bailout programmes. In these auditions, EU officials apparently refuse any responsibility on the policies implemented.

4.5 *Protective security*

A common approach to the problem of aging in the EU is needed. The system of financing the retirement pensions has to be changed and harmonized across member-states. A Tobin tax on capital movements not only could serve to contain speculative movements in capital markets but also could help ensure the sustainability of the social security system in the EU member-states, without the current overload on labour—see Keynes (1936, p. 160) on the same topic, and Grahl and Lysandrou (2014) for a more recent discussion.

There is also the need of an EU response mechanism that could compensate for the lack of ability to react to asymmetrical shocks. This mechanism would ensure that pensions or unemployment benefits would be paid by the EU in times of crisis, not burdening the national budgets—see De Grauwe (2013) on this topic.

5. Conclusions

The financial crisis has revealed the weaknesses of the EU, and of the strategy followed by the *Troika*, which addresses separately and sequentially three aspects that must be seen together, namely financial consolidation, economic performance and social progress. The Treaty of Maastricht and the Single European Market, the Euro and the EU Eastern Enlargement, the Treaty of Lisbon and globalisation underlie the loss of competitiveness of Portugal and its current account deficit and foreign debt. The country was pushed to the bailout by an EU that has intended to take the Eurozone as a simple fixed exchange rate regime (in which the adoption of a single currency serves only to materialize the irrevocable fixing of exchange rates), that has intended to refuse the ECB the role of lender of last resort and that has preferred to break the bonds of solidarity between member-states while violating the EU treaties, rather than contributing to the regulation of financial markets. The main mistake of Portugal was to have failed to understand or to question the evolution of the EU towards the current situation.

To a large extent, the changes that have happened in the EU since the unification of Germany, in 1990, have had their starting point with this unification and with the desire of a few member-states to command the EU through the European Council, restricting the right of initiative of the European Commission. There is also a desire of a few member-states, net payers of the EU budget, to reduce their net contributions. It is unclear, however, the real net contribution to the EU of each member-state, as there are income transfers between member-states not only through the budget but also through the Single European Market.

Portugal has experienced a process of economic and social decline without precedent in the more recent decades. After years of deindustrialization, the accelerated deterioration of the country's productive structure and social cohesion and the emigration of its young and most-qualified people have permanent effects on the supply side of the economy and lead to the acceleration of population aging. The country's future is being compromised because a temporary negative shock on demand (exacerbated by EU policy) is being converted into a permanent negative shock on supply with human capabilities, which are also a means for development, being severely reduced.

The effects of the reduction of demand on human capabilities mean that we are not witnessing short-term demand shocks, but rather a lack of effective demand with long-term effects on potential output. The economic process at stake is not merely a shift away from an equilibrium position which can be easily restored, as presupposed by the EU policies, but rather a path-dependent process of cumulative causation which leads to a vicious cycle of deterioration of human capabilities and loss of potential output which mutually reinforce each other.

For its own sake and for the sake of the EU, Portugal should propose, within a broader framework of discussion on the future of the EU, a strategy that takes into account that financial consolidation, economic performance and social progress are deeply interconnected, and cannot be addressed separately or sequentially. Or, if these three aspects are to be addressed separately and sequentially, they should be addressed in the opposite order to the one imposed by the EU institutions. However, Portugal needs to be prepared for a possible refusal of the European institutions to its claims, and articulate a strategy with other countries for such a scenario. Therefore, the country, together with other key actors, would certainly need to prepare a contingency plan which, ultimately, may pass by its exit of the Euro or even of the EU. To act collectively is essential for a negotiation process with the EU.

There are other aspects Portugal can work on, such as supporting the extension and the control of its continental shelf while deepening its relations with the Community of Portuguese-speaking countries (CPLP) and with the Iberian-speaking countries. It should also approach its emigrant communities in the world, not only to mitigate the difficulties in the present but also for assistance in the process of repositioning itself in the global value chains in the near future.

As human institutions, democratic governments and markets fail. However, both institutions are likely to be improved and to constitute instruments to support development as freedom; that is, as the expansion of human capabilities, within an integrated view of development processes. As Sen (1999, 2011) notes, democracy has an intrinsic value, but it also has an instrumental value, since it is also a means to further development. The present situation in Europe shows that decisions undertaken by technicians divorced from democratic processes do not lead to more enlightened decisions. More than that, the present crisis is leading to the deterioration of democratic institutions, as noted by Sen (2011). Keynes warned long ago how financial markets could be dangerous for democracy. The fate of democracy is closely tied up with the economic and social policy that is followed in the present context. Following the current European policy leads to the destruction of democratic institutions. An alternative that focuses on human capabilities can help maintain the European democratic tradition.

Bibliography

Alesina, A. F. and Ardagna, S. 2010. Large changes in fiscal policies: taxes versus spending, in Brown, J. R. (ed.), *Tax Policy and the Economy*, vol. 24, Chicago, University of Chicago Press

Amaral, J. F. 2013. *Porque Devemos Sair do Euro—o divórcio necessário para tirar Portugal da crise.*, Alfragide, ed. Lua de Papel

Blanchard, O. and Giavazzi, F. 2002. Current account deficits in the Euro area: the end of the Feldstein-Horioka puzzle? *Brooking Papers on Economic Activity*, vol. 33, no. 2, 147–209

Blanchard, O. and Leigh, D. 2013. *Growth forecast errors and fiscal multipliers*, IMF Working Paper 13/1

Bloom, N., *et al.* 2012. Management practices across firms and countries, *ACAD MANAGE PERSPECT*, vol. 26, no. 1, 12–33; published ahead of print 5 December 2011

Casaca, P. and Artamendi, N. 2014. Euro Reform 2014: a proposal on reform of the Euro, report by Paulo Casaca and Nerea Artamendi, with foreword by Lars Hoelgaard, edited by Sander Ruben Aarten, ARCHumanKind, Euro Reform 2014 Options and Possibilities, http://www.euroreform.org/ [date last accessed 6 April 2016]

Costa, L. and Osório, P. 2013. Sobre a reforma política e administrativa do Estado português, *Revista Portuguesa do Estudos Regionais*, no. 34, 3.° Quadrimestre, 11–20

De Grauwe, P. 2013. Proteção social na zona euro, *Expresso*, 1 June, http://expresso.sapo.pt/protecao-social-na-zona-euro=f810978 [date last accessed 6 April 2016]

De Grauwe, P. and Ji, Y. 2013a. Are Germans really poorer than Spaniards, Italians and Greeks? *Vox—Research-Based Policy Analysis and Commentary from Leading Economists*, 16 April, http://www.voxeu.org/article/are-germans-really-poorer-spaniards-italians-and-greeks [date last accessed 6 April 2016]

De Grauwe, P. and Ji, Y. 2013b. Panic-driven austerity in the Eurozone and its implications, *Vox—Research-Based Policy Analysis and Commentary from Leading Economists*, 21 February, http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications [date last accessed 6 April 2016]

Eurostat 2016. Unemployment rates EU-28 EA-19 US and Japan seasonally adjusted. Retrieved from Eurostat, http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Unemployment_rates_EU-28_EA-19_US_and_Japan_seasonally_adjusted_January_2000_February_2016.png#file [date last accessed 6 April 2016]

Galbraith, J. K., Holland, S. and Varoufakis, Y. 2014. *Modeste proposition pour résoudre la crise de la zone euro*, preface by Michel Rocard, Paris, Veblen Institute and Les Petits Matins, 2 January

Grahl, J. and Lysandrou, P. 2014. The European Commission's proposal for a financial transactions tax: a critical assessment, *Journal of Common Market Studies*, vol. 52, no. 2, 234–49

Guedes de Oliveira, F. and Costa, L. 2015. The VAT Laffer curve and the business cycle in the EU27: an empirical approach, *Economic Issues*, vol. 20, part 2, 29–44

Herndon, T., Ash, M. and Pollin, R. 2014. Does high public debt consistently stifle economic growth? A critique of Reinhart and Rogoff, *Cambridge Journal of Economics*, vol. 38, 257–79

Holland, S. 2014. *Europe in Question—And What to Do about It*, Nottingham, Spokesman Books

IMF 2012. World economic outlook 2012: coping with high debt and sluggish growth, World Economic and Financial Surveys, http://www.imf.org/external/pubs/ft/weo/2012/02/pdf/text.pdf [date last accessed 6 April 2016]

IMF 2013. Portugal: rethinking the state—selected expenditure reform options, report by Gerd Schwartz, Paulo Lopes, Carlos Mulas Granados, Emily Sinnott, Mauricio Soto and Platon Tinios, International Monetary Fund (IMF), Fiscal Affairs Department, January, http://www.imf.org/external/pubs/ft/scr/2013/cr1306.pdf [date last accessed 6 April 2016]

Kalecki, M. 1971. *Selected Essays on the Dynamics of the Capitalist Economy*, Cambridge, Cambridge University Press

Keynes, J. M. 1936. *The General Theory of Employment, Interest and Money*, London, Macmillan

Martins, N. O. 2006. Capabilities as causal powers, *Cambridge Journal of Economics*, vol. 30, 671–85

Martins, N. O. 2009. Sen's capability approach and post Keynesianism: similarities, distinctions and the Cambridge tradition, *Journal of Post Keynesian Economics*, vol. 31, 691–706

Martins, N. O. 2011. Globalisation, inequality and the economic crisis, *New Political Economy*, vol. 16, 1–18

Martins, N. O. 2013. *The Cambridge Revival of Political Economy*, New York, Routledge

Mateus, A., *et al.* 2013. *25 anos de Portugal europeu: A economia, a sociedade e os fundos estruturais*, Fundação Francisco Manuel dos Santos e Sociedade de Consultores Augusto Mateus & Associados (AM&A)

OECD 2013. *Portugal: reforming the state to promote growth, OECD 'Better Policies' Series*, May

OECD 2014. *OECD Economic Surveys*, Portugal, October

Portuguese Government 2013. Relatório do Orçamento de Estado para 2014. Retrieved from the Portuguese Ministry of Finance, http://www.dgo.pt/politicaorcamental/OrcamentodeEstado/2014/Proposta%20do%20Or%C3%A7amento/Documentos%20do%20OE/Rel-2014.pdf [date last accessed 6 April 2016]

Reinhart, C. M., and Rogoff, K. S. 2010. Growth in a time of debt, *American Economic Review: Papers & Proceedings*, vol. 100, 573–78

Ribeiro, F. 2009. Portugal 2025—Que funções no espaço europeu? *Prospectiva e Planeamento*, vol. 16, 197–221

Romer, C. D. 2011. *What do we know about the effects of fiscal policy? Separating evidence from ideology, Lecture notes*, Hamilton College, 7 November 7, http://preview.hamilton.edu/documents/Romer lecture notes.pdf [date last accessed 6 April 2016]

Sen, A. K. 1985. *Commodities and Capabilities*, Oxford, Oxford University Press

Sen, A. K. 1992. *Inequality Reexamined*, Oxford, Oxford University Press

Sen, A. K. 1997. Inequality, unemployment and contemporary Europe, *International Labour Review*, vol. 136, 155–71

Sen, A. K. 1999. *Development as Freedom*, Oxford, Oxford University Press

Sen, A. K. 2011. It isn't just the Euro: Europe's democracy itself is at stake, *The Guardian*, 22 June

Stiglitz, J. E. 2002. *Globalisation and Its Discontents*, New York, W. W. Norton

Stiglitz, J. E. 2003. *The Roaring Nineties*, New York, W. W. Norton

Stiglitz, J. E. 2012. *The Price of Inequality*, New York, W. W. Norton

Varoufakis, Y. and Holland, S. 2011. *A modest proposal for overcoming the Eurozone crisis*, Levy Economics Institute of Bard College, Policy note 2011/3