



Gabinete de Estratégia e Estudos
Ministério da Economia e da Inovação

GEE Papers

Número 4

Novembro de 2007

Competitiveness and convergence in Portugal

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Abstract

The complementary package of macroeconomic and structural policies associated with Portugal joining the European Monetary System in 1992 failed because budgetary control was inconsistent with the new currency regime. In its three sections, this paper focuses on the consequences for growth of this enduring policy failure. Its two main reasons were excessive primary expenditure and state-led wage inflation. Reform procrastination and the reversion of a purely demand-led boom is the main lesson from Portugal on what can be called competitiveness for convergence. Reforms are more likely to fall prey to the second-best argument under ready-made policy packages with scant knowledge about local conditions. A more systemic approach to national economies will include the concept of complementarity as an input into economic advice, as shown in connection with transition by Macedo and Martins (forthcoming).

¹ Paper prepared for presentation at a workshop to be held on 5 November, 2007 at the Ministry of Economy and Innovation.

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Introduction: a plug for unity with diversity

This opportunity to bring together some recent work on *Portugal and the Challenges of Globalization* is particularly pleasing for me. Almost five years ago, on December 6, 2002, I participated in a panel with Guillermo de la Dehesa held at ISEG to mark the launch of a volume edited by the current Minister of Economy and Innovation, then on the board of Banco Espírito Santo, titled *Productivity and Growth in Portugal*².

On pages 189-193, the volume reproduced rankings of competitiveness such as the ones presented with an earlier version of this paper at a *Conference on Competitiveness*, hosted by the Bank of Latvia on October 10, 2007. The emphasis on the first attempts of Daniel Cohen at giving an analytical backbone to such ubiquitous rankings, as part of the program of work of the OECD Development Centre on Globalization and Governance (OECD, 2003, p. 35) which I supervised is thus particularly topical. Relentless fighting of geographical and historical determinism is called for, however, because Portugal retains a tradition of ambiguous public response to external liberalization which is not shared by neighboring Spain.

In that connection, I argued in Macedo and Bliss (1990) that the only credible measure to end the direct financing of the Treasury by the banks would then be an agreement among the central bank, the ministry of finance and the spending ministries on a plan of deficit reduction involving both expenditures and revenues, and perhaps including tax reform. Little did I know I would try to do just that by embedding the 1992 budget in a convergence program a few weeks after I was sworn in as Minister of Finance. But I had added that, if this multi-annual fiscal adjustment strategy were too gradual, shadowing the EMS might be the only feasible alternative consistent with opening the capital market before 1996. As it turns out, the budget was consistent with a wage and price agreement based on a target of 8% and the escudo joined the EMS in April³.

On the other hand, the complementary package of macroeconomic and structural policies failed because budgetary control was inconsistent with the new currency regime. In its three sections, this paper focuses on the consequences for growth of this enduring policy failure. Its two main reasons were detailed in earlier work (Macedo 2003, Krugman and Macedo 1979):

- excessive primary expenditure and
- state-led wage inflation.

² My presentation, titled *The Pitfalls of Geographical and Historical Determinism*, is available at <http://prof.fe.unl.pt/%7Ejbmacedo/ISEGPINE/index.htm>. The paper in Portuguese appears on pp. 17-26 of the volume and revises a comment presented at the May 24 conference of the Bank of Portugal where I drew to some new work on industrial productivity done at the OECD Development Centre by Daniel Cohen and Marcelo Soto. Other relevant references, which appeared in Portuguese as *Nova Economics Working Papers* # 493 (2006) and # 502 (2007) respectively, are “Portuguese competitiveness in the global economy” and “The change in Portugal’s currency regime fifteen years after Maastricht”.

³ With decisive help from the Treasury Secretary and his team, restoration of full convertibility of the escudo was achieved in December, in spite of the turbulence of the grid and of the second of four realignments initiated by Spain, three of which the escudo followed at least in part (Braz 1992; Torres, 1996).

Reform procrastination and the reversion of a purely demand-led boom is the main lesson from Portugal (Abreu 2006; Ahmed and Bakker 2007) on what can be called competitiveness for convergence (C4C). Last this is seen as historical determinism, recall from Krugman (1991) the parameter combination for expectations-led convergence: the interest rate must be lower than the combined effect of increasing returns to scale and speed of adjustment.

1. Productivity and growth in Portugal revisited

Reference was made at the outset to *Productivity and Growth in Portugal*, an influential volume which reproduced rankings from the *World Competitiveness Yearbook 2001* showing Portugal climbing from 32nd in 1997 to 27th in 1999, only to drop to 34th in 2001. As is increasingly recognized, and was pointed out at the Bank of Latvia conference where this paper was first presented, such ubiquitous rankings are difficult to interpret without an analytical framework, such as the one provided in Causa and Cohen (2006), to which we turn after linking Portugal’s relative growth record to industrial productivity relative to rich countries. C4C is a policy link between productivity and growth which takes into account the factors of industrial competitiveness on the one hand and growth in main trading partners on the other. The share of primary government expenditure in GDP, budgetary procedures and relative unit labor costs also help assess the credibility of policy.

Figure 1 shows Portugal’s GDP growth rate relative to that of the EU15 from 1961 to 2008, together with averages by head of government. The effect of international recessions is clear, together with a trend decline in the rate of convergence from 2% p.a. in the 1960s. The data come from the AMECO database with the revisions of the spring 2007 forecast (the interim forecast only affected large countries and Spanish growth was left unchanged). The criterion for a government average is the same prime minister except for 2004/2005 when there three prime ministers but one tenure was too brief to be reflected in the data.

Figure 1 - Growth relative to EU15 1961-2008 and averages by head of government



The boom following the 1995 general elections was short-lived: divergence with the EU15 average started in 2000 (the rate would be higher by about .2% with respect to the EU27 average). Unlike previous episodes, this one went well beyond the international trough.

This pattern serves as background to comparisons of industrial productivity and a call for broad-based and sustained reforms are the strategy to meet the challenge of convergence. Accelerated convergence implies a strong macroeconomic framework, structural reforms and social cohesion. Reforms have different time frames depending on the institutions which need to be changed. In addition, policies are closely interrelated. Even leaving out social policies, this applies to fiscal and monetary policies, macroeconomic and structural policies and across structural policies. As a consequence of the time- and issue-interdependence of reforms, fragmented (piecemeal) policy implementation creates fragilities, which can lead to crises and policy reversals.

For example, international competitiveness and human capital policies interact. The Lisbon ambition for the European economy to become the world's most competitive economy by 2010 implies policy coherence and provides many structural indicators to be monitored, but the complementarity between real exchange rate, relative prices and human capital policies needs more attention. When real exchange rate adjustment is constrained by Economic and Monetary Union, relative prices between tradable and non-tradable goods and services may hinder the development of the traditional tradable sectors. This requires greater coordination between the public and the private sectors in terms of human capital investment (education & training).

Similarly, relative prices and product market policies interact: When real exchange rate appreciates, there are strong upward price pressures in the non-tradable sector (e.g. services), which require an appropriate framework for competition policy and regulatory reform. In the EU, competition policy and regulatory reform are part of the Lisbon Strategy, but the complementarity has also been overlooked.

An immediate interpretation in terms of the reform process is that trying a partial reform, reverting to a non-reform state and then undertaking another partial reform yields a lower overall return than carrying out a broad-based reform. This means that, just like a proportional reduction in distortions improves welfare, joint implementation of complementary reforms does too.

To provide a first snapshot of the potential complementarities existing across blocks of reforms, interdependences between liberalization, stabilization, financial reform, exit and entry mechanisms provide examples of the policy feedbacks, in the sense that implementing one reform block helps in the implementation of another. These linkages are at the centre of the transition process. Several OECD studies in this area concluded that it was more important to ensure that these links operated adequately rather than pushing reform in any single area, including institutional development. One important implication of what amounts to an implicit preference for complementary reforms is that policy reversals can magnify the costs of transition (reduce the benefits of reform), perhaps jeopardizing progress in the most advanced policy areas.

When several aspects of reform are mutually interdependent, changing one without changing another is unlikely to lead to a well-balanced and functional system and the expected benefits from reform may not materialise. The concept of policy complementarity has been largely absent from development and transition

literature, but results for the European member countries of EBRD, allowing for the endogeneity of policies, given the institutional environment, confirm the importance of this concept for emerging markets⁴.

The open cooperation procedure used in the Lisbon Agenda has proven difficult to implement but has recently been adapted to the new members, while the Agenda itself has been streamlined and refocused at the 2005 Spring Council. While no ‘name and shame’ has been agreed at the head of state and government level, accountability has emerged at the sectoral level.

The C4C approach reflects the need to prioritize the reforms with the greatest pay-off in terms of growth, convergence and social inclusion. The challenges of global competitiveness should be underpinned by appropriately focused analytical work on: (i) the complexity of the reform agenda and the difficulty of its implementation; (ii) the expected medium-term, as opposed to longer-term, development pay-off; (iii) the cost of compliance with the Lisbon Agenda. These three criteria determine whether the existence of losers (as attitudes often display fear of change and a bias in favour of the status quo, even when the outcome turns out to be favourable, the argument applies to the expectation of losses, even if they are not realized) prevents the adoption of needed reforms.

The importance of product market competition as a signal that policy design is broad based rather than a succession of individual sectoral reforms is evident in the advice currently provided to Portugal, for example by Rodrik, who places a lot of emphasis on technological changes, and on getting things to work better or improve the total productivity of factors.

Contrasting productivity levels across countries for the 1990s, Cohen (2002, p. 59) found that the average income per capita in poor countries, excluding Sub-Saharan Africa, was 25% that of rich countries. In his formulation, total output is given by a weighted average of physical capital (denoted by K) and the labor force (denoted by H augmented by human capital, a combination of years of schooling, labor experience and health) and a scale factor measuring total factor productivity (denoted by A): $Y = A K^{\alpha} H^{1-\alpha}$. Human capital is 58% that of rich countries, while the relative shortage of physical capital is at 65% of the figure for rich countries and total factor productivity is also at 65% of the figure for rich countries.

Although the gap in each one of these terms does not seem disproportionate on its own, together they result in an income gap of 75%. Cohen used revised estimates of human capital and concludes that a typical firm in a developing country is not as far as it may appear from a firm in a rich country: not far from the frontier of total productivity, and not far from the level of human and physical capital either, but it is far enough to need to solve all three problems together.

In concluding this project, Cohen introduced infrastructure (measured by electricity generating capacity) as a factor of production and integration with the international trading system as a component of the residual, so that total industrial output is now given by: $Y = K^{\alpha} Z^{\beta} H^{1-\alpha-\beta} TFP$, with constant returns to scale prevailing in the three arguments and total factor productivity allows for the effect of trade integration (T^{θ}) in addition to the residual A . This model of industrial productivity, estimated for the period 1990-1999 using UNIDO data, is relevant to aggregate productivity in the future, because industrial goods are internationally traded and very important for investment. In order to assess competitiveness and barriers to foreign direct investment,

⁴ Macedo (2007a) relates recent work on this subject to the regime change in Portugal.

therefore, expressing industrial productivity levels can provide more insights than using aggregate economy variables.

This is why the message of C4C also attempts to ensure competitive and investment-friendly product market regulations; fostering increased technology absorption and innovation; aligning worker skills with private sector needs; improving the quality and lowering the cost of infrastructure services and furthering financial sector development to mobilize finance for productive investment. The factors explaining industrial productivity reflect factor endowments but also institutions as broad as social capital.

Table 1 ranks some fifty countries in descending order of industrial productivity as measured by the export potential and Table 2 provides the actual values of the factors in the production function used in the estimation. The differences in physical capital per worker (K) are much less pronounced than in productivity (Y, Prod), as this is not a constraint for the international investor. The country lagging furthest behind is at a level of close to 80% of the rich countries. In other words, most of the difference comes from the other factors.

Table 1 - Ranking of export potential (Expor) and attractiveness to investment (Invest)

Country Ex	por	Invest	Prod	Country Ex	por	Invest	Prod
Belgium	4	12	6	Morocco	30	42	43
Spain	7	17	17	Egypt	32	49	47
Portugal	15	30	30	Fiji	33	43	44
Hungary	17	40	45	Honduras	34	45	49
South Africa	20	31	31	Jordan	38	27	40
Malaysia	23	32	32	India	40	51	50
Costa Rica	25	39	46				

Source: Causa and Cohen (2006)

Grouping the factors of infrastructure (Z) and trade integration (T), a proxy for the attractiveness of the country as a platform for industrial production ($T*Z$, Expor) is obtained. Portugal fares well on this score, with over 80% (94% on each factor), while Turkey is at about 60% and Morocco close to 70%. Combining human capital (H) and the residual (A), a proxy for worker efficiency is obtained. The two composite factors reproduce the industrial productivity differences from the perspective of an investor ($H*Z*T*A$, Invest) who can supply K.

This is another way of saying that, while physical capital is fairly uniform, Portugal is Greek in trade integration and infrastructures but Turkish with respect to capital. Spain is uniformly higher, except for the very high residual in Turkey, 60% above the rich countries average.

Table 2 - Industrial productivity 1990-99 (rich countries =1)

Y		H	K	Z
Spain	0,7	0,8	0,9	1,0
Greece	0,5	0,8	1,0	0,9
Turkey	0,4	0,6	0,9	0,6
Portugal	0,3	0,6	0,9	0,9
T		A	Z*T	H*A
Spain	1,1	1,0	1,0	0,8
Greece	0,9	0,8	0,8	0,6
Turkey	0,9	1,6	0,5	0,9
Portugal	0,9	0,6	0,9	0,3

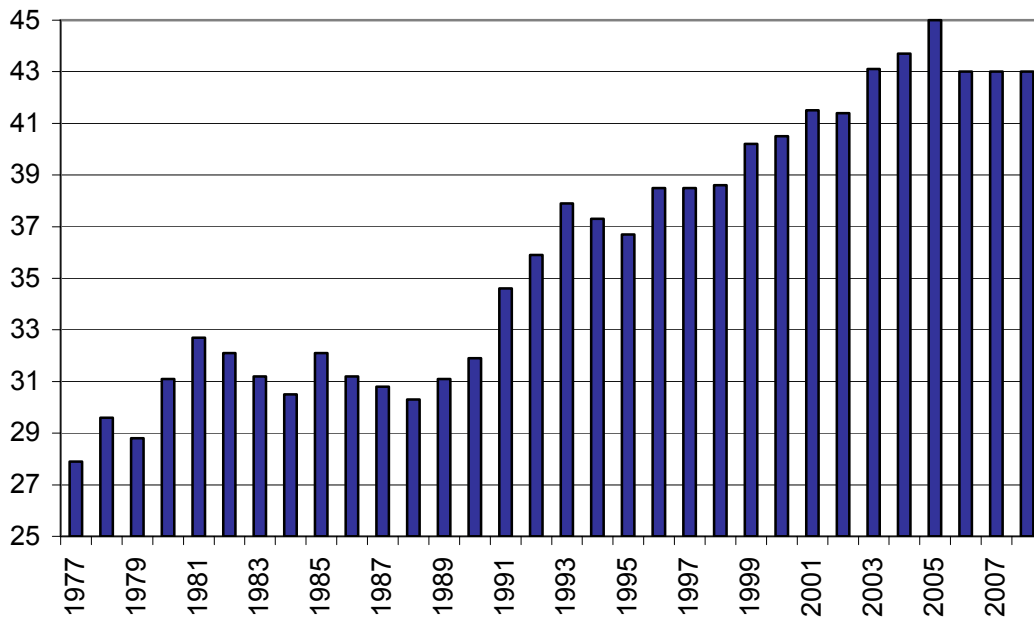
Source. Scores on which the Prod rankings on Table 1 are based.

2. Power to the Minister of Finance over the budget

As a European Commission official dealing with transition economies in the early 90s, I observed that the Ministry of Finance tends to be weak in Soviet type systems, certainly compared to the Gosplan. The first provisional government after the April 25th revolution featured a Minister for economic cooperation rather than for finance. Yet the low power of the Minister of Finance over the budget is often not seen as a problem. In fact, the opposite is true: a strong Minister of Finance only fits in a dictatorship. Financial freedom is so bad that it leads to what Krugman (2007) calls “incestuous suppression”, the stuff of political and monetary myths, like asserting that political freedom and financial freedom are inimical, instead of being complementary, neglecting future policies and their sustainability, rather than insisting on the rights and guarantees that democracy is supposed to provide today, and forgetting about tomorrow. The fact is that, when the escudo joined the EMS, people were still used to the mind set of inflation, rooted in a civic culture which pits political freedom against financial freedom, and democracy against hard budgets.

Figure 2 shows the enduring inability of the government to reign in public expenditure, suggesting that budgetary “fragmentation” has been responsible for almost a decade of real divergence. The source is as in Figure 1 and it is not available before 1976. The change in budgetary procedures in 2006 is noted in the article IV mission report from the IMF dated June 2007 and reported in the Bank of Portugal website.

Figure 2 - Primary expenditure % GDP



As I described in Torres (1996), between 1985 and 1995, Prime Minister Cavaco Silva (who was a former Finance Minister) ensured the strategic dominance himself, alternating between Ministers who earned credibility abroad at the beginning of the mandate and Ministers who sold stability at home in the run up to new elections. But there was no constituency for globalization and a residual fear about “choosing” between Europe and Africa remained from both the Salazar and the revolution. The 1995 elections brought to power (in a minority government) Prime Minister Guterres, an engineer without economic background who took the public administration portfolio into his office (under the slogan “no jobs for the boys”) and gave the late Sousa Franco (a former judge from the court of auditors) the mandate to qualify for the euro. This led voters to believe in the regime change but the deficit bias was exacerbated, especially after qualifying for the euro. Domestic structural reforms also stopped⁵.

The delegation to the Minister of Finance remained weak under Pina Moura and Oliveira Martins until Guterres resigned in the wake of defeat in December 2001 local elections. After the opposition won the 2002 general elections, a majority coalition government reinforced delegation to Ferreira Leite. She acknowledged the violation of stability pact and introduced emergency restrictive measures during the downturn. Delegation was weakened again by a new government of same coalition, who gave conflicting signals about pursuing budgetary consolidation, precipitating general election in February 2005. A majority socialist government led by Prime Minister Socrates gave a weak delegation to the Minister of Finance (former independent central bank official) – who resigned after 4 months. In 2006, the reform rhetoric grew louder based on the strategic

⁵ Hagen (2003) reinforces this argument with the dates of parliamentary and presidential elections between 1998 and 2001, showing how these had a significant effect on the budget deficit of the previous year. Portugal registers three such dates, a Finland two and the remaining 13 countries one.

cooperation between President of the Republic and Prime-minister. Nonetheless, the strength of the delegation to the Minister of Finance has not been tested and it is not known whether Teixeira dos Santos is supposed to earn credibility abroad, sell stability at home, or both. This is relevant because the Prime-minister is no longer the super-Minister of Finance he was in 1985-95. Moreover, uncertainty remains about fiscal consolidation as the process remained “fragmented” for so long⁶.

Table 3 Power of Minister of Finance over the three phases of the budget

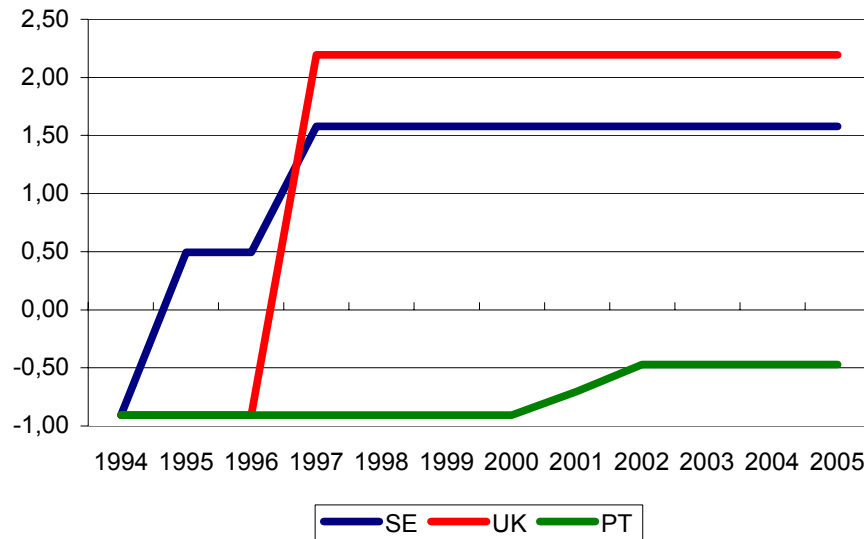
Countries\Phases	Formulation	Approval	Implementation
Portugal	0,1	0,3	0,5
Greece	0,1	0,8	1,0
Average EU15	0,5	0,7	0,6
Min (Sweden)	0,4	0,5	0,0
Max (UK)	1,0	0,9	1,0

Source: Adapted from Hallerberg et al (2004)

In Portugal, the Minister of Finance had little power over the budget because procedures were not appropriate. When they were appropriate, moreover, they were not implemented, as noted when comparing the various stages of the budgetary process in detailed. Institutional analysis brings out the formal and informal rules governing the drafting of the budget law (formulation), its passage through the legislature (adoption) and its implementation distribute strategic influence among the participants in the budget process and regulate the flow of information. Around 2000 a survey was carried out in the European Union, according to which the Minister of Finance’s power over the budget has the lowest score in Portugal (Table 3). It turns out that the Swedish score stems from the fact that the implementation phase is not carried out by the Ministry of Finance.

⁶ International Monetary Fund (2004, p. 94).

Figure 3 - Fiscal rules in Portugal, Sweden and UK, 1994-2005



At the 46th *Economic Policy* Panel Meeting, held in Lisbon as the country currently holding the EU presidency, Alessandro Turrini presented a welcome update of these scores, based on work carried out by the European Commission and the IMF (Ayuso-i-Casals et al, 2007). He was kind enough to provide me with his data base, from which Figure 3 is taken. Portugal’s score is equivalent to the absence of a numerical rule. It improves marginally in 2002 but remains well below the EU 27 average, constructed to be zero. The problem has not gone away.

3. Handling real appreciation

Figure 4, while showing some decline in volatility, suggests a sustained real appreciation of the currency. The series is not available before 1971. There is a basket of 35 currencies available after 1995. The negative consequences for competitiveness of too low a relative price of traded to non traded good and an excessive level of spending were exacerbated by the procrastination on structural reforms. While nominal devaluation is no longer an available policy measure, it helps to provide new evidence on how “geographic fundamentals” made it a stopgap measure already well before joining the euro⁷. As mentioned above, external credibility was reached with full convertibility and confirmed after the widening of the bands in August 1993, even though another realignment was going to take place before the creation of the euro. Table 4 shows that contagion only occurred from peseta to escudo but not the other way around.

⁷ Additional evidence on past devaluations together with a blow by blow account of the regime change are found in Macedo (2007b)

Figure 4- Real Effective Depreciation (Unit Labor Costs In Portugal Relative To 23 Partners, 1971-2008, Annual Change And Government Average)

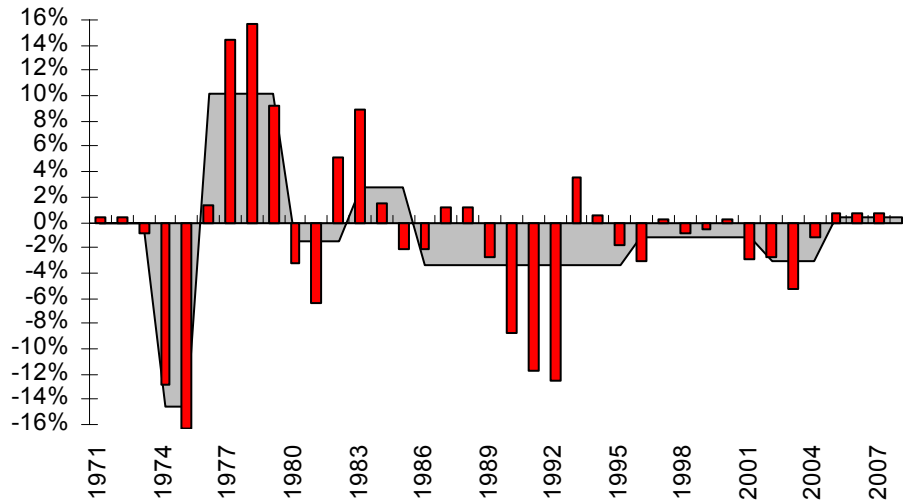


Table 4 - Contagion between escudo and peseta in a model with variable correlations and volatility states determined by the interest differential with Germany

Effect of differential on probability of currency going from high to low volatility	Correlation varies with escudo	Correlation varies with peseta
Escudo	-0,2	-0,2
Peseta	0,3	0,4
Correlation low volatility	0,7	0,6
Correlation high volatility	0,7	0,8

Source: Adapted from Lopes (2006). All coefficients significant at 5%.

This asymmetry would be even stronger if the escudo were not in the ERM, since even when the two currencies are in, an increase in the interest rate differential when Portugal is in a crisis state lowers the probability of exit from the crisis, a “perverse expectations effect” which does not obtain if Spain raises the interest differential. These results qualify previous analysis about interventions when fundamentals were seen as determinant in the wide band period. Taking into account the correlation between the two Iberian currencies reveals that fundamentals in Spain affected Portugal but the converse was not true. The sample used begins after the restoration of escudo convertibility because data on the domestic interest rate differential was not available before that date. The correlation is 0,5 until 31 March 1993, increasing to 0,7 after April. More importantly, in Table 4 the correlation between escudo and peseta does not change with escudo volatility but it jumps from 0,6 to 0,8 when the peseta goes from low to high volatility.

The fears about “geographic fundamentals” often expressed in this context suggest that for the escudo to always follow the peseta would have prevented any positive differentiation, whereas ignoring the peseta would not have been credible. This suggests in turn that having remained outside of the ERM during the turbulent period would have been likely to exacerbate contagion, or require a drastic tightening of capital controls instead of their dismantling before the end of 1992. There is no evidence that the drachma might have a similar contagion problem, so that ERM entry for the drachma was not as urgent as it was for the escudo.

Conclusion

In models with multiple equilibrium development paths, a country can escape being the prisoner of history, of past policies and achievements by following an expectations-driven path depending on three observable parameters (Krugman 1991). One parameter, which has to do with intertemporal trade, is the interest rate. It must be lower than the combined effect of increasing returns to scale and speed of adjustment. Aside from technology, then, we find flexibility as a guide for institutional change.

Flexibility includes the ability to exploit the complementarity between macroeconomic and structural reforms. Yet there is relatively little attention to the design of reform packages and its effects on economic growth, suggesting that, when there are many distortions, eliminating only few of them may threaten the sustainability of the reform process. Reforms are more likely to fall prey to the second-best argument under ready-made policy packages with scant knowledge about local conditions. A more systemic approach to national economies will include the concept of complementarity as an input into economic advice. When starting a reform strategy that deliberately results, in its initial stages, in a reduction of economic coherence, countries incur a risk. While it may be rational to bear that risk, it cannot be systematically ignored without facing long-lasting negative consequences.

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