ANXIETY, HOPE AND DISCIPLINE

ECONOMIC CRISIS AS PORTUGAL'S OPPORTUNITY

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English Circulation Draft

(from the draft sent to translation)

Recently I have had the great honor of being asked what I think about the Portuguese situation, and more specifically, how one might go about restoring market confidence under the difficult circumstances in which Portugal finds itself. On a program sponsored by the US State Department, I have spoken to and with a variety of official, business, and academic audiences in Portugal. (The opinions expressed here are my own, and do not represent positions of the US State Department or the US Government.) I have tried, as a sympathetic outsider professionally concerned with political economy, to think about what current events mean, and to imagine how Portugal might respond. This "Letter to Portugal" is thus both an effort to do political economy in an accessible fashion, and to present some thoughts that might be helpful.

This Letter has two parts. In the first, "From Stability to Flexibility," I argue that Portugal will change, and for the better. I am hopeful. This time will have substantial difficulties, but the challenge – and the opportunity and even adventure – is to make the best changes possible. In order to meet that challenge, I argue that Portugal (and by implication, Europe), should begin to think of political economy in terms of "flexibility" in place of the "stability" that so dominates contemporary policy thought.

In Part Two, "Practical Steps Toward a More Flexible Portuguese Economy," I will discuss some ways that a more flexible economy might be constructed. I will discuss the Troika's Memorandum of Understanding, and add some additional ideas that seem worthy of political discussion.

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PART ONE: FROM "STABILITY" TO "FLEXILIBILITY"

Hope. Let me start by being perhaps provocatively optimistic: there is much reason for hope, and even more reason to insist that hope is important.

Why is there reason for hope? One reason is that finance is usually conceived in essentially "private" terms. The discipline of finance tends to be concerned with how businesses and households go about their affairs, and therefore those who think about finance tend to see the world in terms dependent on this professional imagination. As a result, an important truth is often overlooked: sovereign debt, and national finance generally, are quite different from commercial debt, and the finance of individual companies. A company, even a very big company, can go out of business in a way that a country simply cannot. Portugal has been here, as a country, for a thousand years. It will be here when we are gone. Portugal is a pleasant place to be, with much to recommend it. Moreover, Portugal has made great strides over the last long generation, since the move to democracy. So the present difficulties, as serious as they are, need to be kept in perspective. Over the medium term to long term, I am confident that Portugal will continue to attract capital and so forth.

This is not to say that the problems confronting Portugal are not serious. I think Portugal's difficulties are so serious that they raise structural (and in that sense constitutional) questions. Portugal will emerge from this difficult time with a different economy, and so in some ways will become a different country. That said, and to sound maybe too American, such challenges are best faced with confidence and energy: everyone should take a deep breath and relax (before getting to work!).

I freely admit that working down excessive debt ("deleveraging") is unpleasant, whether in Portugal or in the United States. And I also know from history that other, considerably more frightening, scenarios are imaginable. People could panic. They could riot. We could be talking about civil unrest and capital flight. The state could even fail. And then we would be facing an entirely different – and much worse – situation. But I simply do not believe that Portugal is at much risk of anything so horrible.

Considerably more likely is a sort of general depression, which has been called a "malaise" in the United States, perhaps best represented by Japan's rather long loss of faith in itself over the last decades. Britain also went through a long period of apathetic self-pity in the sixties and especially 1970s. Such attitudes make it very difficult for an economy to recover after a downturn.

And I do understand that a kind of sweet melancholy is one of the more refined characteristics of Portuguese culture, hence *fado*. But existential and artistic matters aside, I sincerely hope the Portuguese do not lose their confidence, their sense that this is a good place to live and to work, to do things. In the US we would say, we don't want the Portuguese to lose their "mojo." Because it is only with mojo, with confidence and a willingness to give something a try, that new businesses are undertaken, that economies renew themselves and flourish. So there is reason for hope, and just as importantly, maintaining hope is vital.

Political moment. Perhaps strangely, I want to suggest that politics provides further reason for hope. Discussion of the sovereign debt crisis – not just in Portugal but across Europe – tends to be far too dependent on a conceptual opposition between "politics" on the one hand, and "economics," on the other. So we often hear it confidently announced that we understand the economics, but the problem is "political." Well, no – this is a bit too convenient, somewhat like the old claim that Marxism has never been tried.

To begin practically: once it is understood that governments will guarantee the functioning of banks – more generally, of the financial system – then the distinction between public and private debt becomes much less important. To oversimplify: in Ireland, the government is indebted because the private banking system became insolvent; in Portugal, the banks are threatened largely because the creditworthiness of the government, whose debt they hold, is in doubt. In both places, the political system is deeply implicated in the problems of the banking system, and conversely, a healthy financial system is vital to the operation of society and hence the political system. That much, at least, is as it should be: markets are a part of the social order, as are governments. As a result, however, it must be acknowledged that economics cannot escape politics, however much one may wish to seek refuge in technocracy.

Although bankers tend to blame "the politicians" who interfere with an otherwise perfectly functioning market (!), and while politicians have been known to blame the greed of bankers (and even worse, "speculators"), the fact remains that we are talking about political economy. Markets are ways in which certain kinds of collective ends are achieved, and are therefore political. Markets are social mechanisms through which, for example, houses are constructed and distributed, and more generally, the primary mechanisms through which Portuguese society provides for the material well-being of the country's inhabitants. And markets are vital to the construction of that youthful political entity known as "Europe."

The current crisis means that various Portuguese markets, notably banking, will change. Without casting blame, the business model followed by the Portuguese banks since accession to the EMU is no longer viable. The country cannot function without a financial system. The status quo is literally unsustainable: business as usual cannot go on. So as a logical matter, Portugal will change, and the question is how. If we presume that the crisis will bring change, we are obligated to try and make change for the better. That is, the present time should be understood not merely as a crisis – which it is – but also as a time of opportunity. As Obama's advisor, now Mayor of Chicago, Rahm Emmanuel, famously said, "You never want a serious crisis to go to waste." If Portugal seizes this moment, this could be a time for real renewal.

What sorts of markets are we attempting to foster? What should the market for sovereign debt in Europe, for relevant example, look like, going forward? What about banking in

Portugal? Or housing in Spain? Various markets are imaginable, but what sort of market seems most sensible in this or that specific situation? What sort of regulatory structure is likely to foster such a market? These are core questions for political economy.

Now is the time to address such questions, precisely because the times are uncomfortable. History teaches that change comes, and real political opportunity arises, on the heals of crisis. For examples, the structure of the US financial system is essentially a response to the Great Depression, and most of the institutions of public international law, from the UN to the WTO, respond to World War Two. Under normal circumstances, the status quo ante reigns, but crisis – the failure of the status quo – makes people willing to try something new. Moreover, as a pragmatic matter of political maneuvering, the "intervention" of the troika (the EU, the ECB, and the IMF), gives Portuguese political parties a degree of breathing room: the troika can always be blamed for whatever difficult steps must be taken. The IMF, at least, is quite accustomed to playing this role.

Designing Markets. So how can we imagine the Portuguese economy, and how can we get there from here? Such questions are, of course, historically and culturally constrained. Portugal will remain Portugal – which is a place quite different from Spain, to say nothing of Germany. And the general European social contract is not really up for discussion. Within such broad parameters, however, the present crisis presents Portugal with the opportunity to consider its markets, and to ask whether such markets are healthy, serve the country well.

Few would dispute the proposition that many markets in Portugal function badly. Discontent with the status quo suggests at least a tacit understanding of what a given market should look like: different from the current, dysfunctional, situation. That is, it is in discontent – negation of the status quo – that we begin to find the principles for reform, an idea that I shall develop and employ below.

To put this point in perhaps more familiar language, the present circumstances demand business models, images of how Portuguese markets could work. Business models, in turn, require action plans: how is the model to be achieved? That is, Portugal needs a credible story of how the nation will pass through this crisis and renew itself.

This story must be believable both to the international financial markets, and to the Portuguese themselves, so that they invest in it. If such a story is told and believed, however, and confidence and then investment returns, then we have yet another reason to be hopeful. If a convincing story can be told about how a better Portuguese economy is being constructed, and that story is then acted upon by both Portuguese and foreign investors (who invest capital and effort), then the story may well come true. Good business models, accompanied by credible action plans, carry the seeds of their own achievement.

I understand that many people understand "the market" to be given, a reality with which politics must cope. From this perspective, my talk of creating a Portuguese (or European) economy may seem hopelessly ambitious. The economy creates us, not the other way 'round. Or so some believe. And even if one does not indulge material determinism, one might think that economic power lies in Berlin or Frankfurt, or maybe Brussels or Washington, but certainly not in Lisbon. In this view, the Portuguese are acted upon, but not actors.

I disagree in many ways, but in the interest of brevity, it may be helpful to think of markets on the analogy of games. Like games, markets are contexts where relatively autonomous actors compete according to a set of rules. Society benefits from the output of the game (the beauty of football, for instance), or the market (in houses, or milk, or commercial credit). And the rules of the game affect both how the game is played, and the "shape" of the outputs, just as regulation affects the terms of competition, and ultimately, what is produced, with what externalities, and at what price.

Finally, and importantly, the game must be perceived to be fundamentally fair, or else nobody would want to play. In sports, one suffers a few bad calls from the referees as part of life. But the game should not be fixed. Neither should markets. In financial terms, the formation of liquidity presumes the willingness to participate in the market. The Portuguese will make their national markets by their participation; a market *is* the collective participation of its actors.

So what sort of markets do the Portuguese want to participate in? What kind of story can Portugal tell itself about how it is developing, now, through this crisis? Can we already see the outlines of a business model for the new Portugal? And, as will be discussed in some detail in Part Two of this essay, how does the Troika's MOU further the realization of that model?

Such questions are merely different ways of asking how the Portuguese are going to reimagine their economy, and thereby some significant portion of their society. Reimagining the Portuguese economy means that market confidence is not, strictly speaking, restored. When financial market and domestic confidence come back to Portugal, it will be confidence in a new – and I hope and think better – economy. *After the crisis, marketplace confidence will be inspired rather than restored.*

Flexibility and Systemic Risk. For the sake of clarity, allow me to suggest an idea without preliminaries, and then develop it post hoc. Portugal should begin think about "flexibility" in lieu of "stability" as a dominant aesthetic in its political economy. I would also suggest that a more flexible structure is a stronger structure, more worthy of confidence.

To state matters positively: this crisis gives Portugal (and indeed Europe) an opportunity to find ways to think more "loosely" – flexibly – about economic policy, and particularly about the relationships among institutions and sectors of the economy. They have the opportunity to build more dynamic, resilient, better markets.

To state matters negatively, Portugal (and indeed Europe) need to think about their markets in new ways, because the old model has failed, or at least been permanently compromised, hence the crisis. At least since the Maastricht Treaty, European markets have been considered under the flag of "stability" – as in the "Stability and Growth Pact." Stability and growth were to be achieved by conformity to certain norms. The Maastricht Treaty contains no provision for sovereigns to exit EMU, be bailed out, or to default – indeed, no provision for crisis resolution at all. Crises were simply to be avoided by conformity to norms of fiscal prudence, i.e., governments would restrict their budget deficits to 3% of GDP. Moreover, it was thought that such conformity to fiscal norms would lead to growth. At least in Portugal, neither conformity nor growth was ever substantially achieved, and now stability has been lost too.

In Portugal, the norm of stability justified excessively protective labor markets; enormous benefits for the unemployed; and implicit tolerance for anti-competitive practices. Solicitude for settled expectations may also lie at the heart of company law excessively devoted to protecting creditors, thereby discouraging entrepreneurship. Be that as it may, in general, law and policy in Portugal have fostered an economy geared to preservation of the status quo, rather than to organic change.

But what do I mean by this "flexibility" that I propose serve in lieu of "stability" as a primary virtue of political economy? One may understand "flexibility" more deeply by thinking about systemic risk. Many seemingly disconnected institutions are in fact highly connected, so that distress in one institution or market can cause a crisis somewhere else. Internationally, Lehman Brothers stands for this proposition. In the United States, reforms since the financial crisis (Dodd-Frank) have attempted to trace, and contain, the systemic risks produced by such connections among institutions.

While Portuguese financial markets are not as institutionally complicated as those in the United States, I think there is a much higher degree of institutional integration – and hence transmittal of risk – than is commonly acknowledged, and a key vector of that risk is sovereign debt. To be a bit more specific, if we look back over the medium term in Portugal, say to accession to the EMU and the Euro, a story something like this emerges.

At least since adoption of the Euro in 1999, Portuguese households, businesses, and government took on substantially more debt. Rising levels of personal and non-financial commercial debt were funded by Portuguese banks, which financed much of their lending by borrowing on the international markets. Portuguese banks were too big to fail, were involved in public private partnerships, financed state-owned enterprises, and in some important cases were owned by the Portuguese government outright. For all these reasons, Portuguese banks had access to capital at very favorable rates. Making money on the spread, Portuguese banks could be expected to be enthusiastic about lending, i.e., willing to extend further credit.

In a related matter, the government employed a large number of people, put in place a generally rigid labor market, and insured generous benefits for the unemployed. Under these conditions, individuals with jobs are presumably good credit risks, further encouraging borrowing. Government also entered into a considerable number of public/private partnerships, often funded – conveniently off the government budget – by Portuguese banks.

In the part of the story that receives the most attention, the government financed its efforts, especially in response to the stress of the financial crisis of 2008-09, by recourse to the international debt markets. European banks, many of which were having difficulty managing enormous amounts of liquidity, and who also bought opaque debt products in the United States, happily extended credit to their fellow Europeans at what was perceived to be essentially zero risk, and (not) reserved against accordingly.

Once the debt crisis emerged in 2009, and Portuguese banks began to have trouble financing their operations in the financial markets, they began buying Portuguese sovereign debt, which could be used as collateral at the ECB, despite the deteriorating creditworthiness of the Portuguese state. All of this took place in the context of an aging population, flat growth over the last decade, and demonstrably undisciplined political and especially budgetary processes, problems hardly unique to Portugal.

Thus consumers, firms, banks, and the government in Portugal all became overleveraged, and all exposed to each other's weaknesses, in a deteriorating demographic, political, and ultimately credit situation. For a variety of reasons, the relevant actors did not perceive increased leverage as a problem, and everybody lent to one another. Until, in late 2009, it became apparent that leverage was a problem for European sovereigns, beginning with Greece. The rather sudden realization that the risk of sovereign debt default was not negligible, i.e., required thinking, forced examination of public finance across Europe. Credit ratings were downgraded; liquidity began to dry up. In due course, it became clear that Portugal would not be able to meet obligations falling due on June 15th, 2011, and looked to the troika for help.

From the perspective sketched here, the Portuguese crisis is not simply the result of excessive borrowing by a government and imprudent lending by international investors. This is the tale of an interconnected system that leveraged itself beyond its short and medium term capacity to pay. It is now necessary to deleverage the system, let air out of the balloon. This is unavoidably painful.

As an aside, and taking the longer view, the Portuguese crisis is hardly shocking. Portugal was a latecomer to the European project, and the last long generation – since the late 1970s – was marked by the adoption of European standards, and European costs. Expansion of credit to meet such rising expectations is a classic story of capitalism. And in the history of capitalism, the valleys are rarely as low as the peaks are high. To use a American example, the commercialization of the internet led to an enormous stock bubble, and enormous losses. But the internet remained. So while it cannot be denied that Portugal borrowed far too much, it must also be remembered that Portugal has become a substantially different, and substantially more modern, country. Markets produce, but they also overshoot the mark. This is not new.

Apart from endurance, however, what can Portugal learn from its recent history that will be useful going forward? As already suggested, a rather straightforward institutional design principle emerges: surely one does not want to restructure the economy in such a way as to recreate the conditions that led to the crisis. With an eye to the present crisis, and systemic risk generally, what I am suggesting is that we should try to see a richer socioeconomic ecosystem, in which the distress of one institution – say a major bank, or the debt of a country, even, does not endanger associated institutions. A little more "give" in the structure, hence "flexibility," would make the system stronger.

Therefore, where Portuguese (and European) markets have been highly interdependent, one would like to see more institutional independence. Where there has been excessive conformity ("harmonization" in Eurospeak), one would like to see more diversity. Where there has been centralization, a bit of decentralization may be in order. Where there has been rigidity, flexibility should be encouraged. Instead of stability among few actors, one should hope for markets that are more open, dynamic, and robust. In short, the sovereign debt crisis may be an important turning point in the way political economy is imagined and conducted in Portugal, and indeed in Europe.

Modesty. I should at this juncture make clear that a turn to "flexibility" does not imply what Europeans call a "liberal" distrust of government per se, nor even an argument that markets are inherently efficient, beloved by classical economists. Having watched a great deal of private sector inefficiency in recent years, that simply is not the point. More importantly, as suggested already, markets are hardly "private" concerns, but are forms of political life, dependent on other forms of political life, notably a well functioning legal system. The point here is to ask, how should markets be constructed in Portugal? A market is well constructed for its society if it generates the sorts of outputs the society wants, at a reasonable cost, and does not fail too spectacularly. Which is easy to say in the abstract, but is no small achievement for a country, as recent history demonstrates.

If we are unsure of market efficiency, we should not be too sure that we know when an economy will grow, or at what rate. As a corollary, it is hard to know when marketplace confidence (what economist Paul Krugman calls "the confidence fairy") will return. The economy may grow, and it may not.

Growth is the *deus ex machina* of a great deal of economic policy, and especially crisis intervention. We would like to say, after this crisis is over, that austerity measures were employed; the capital markets were repaid and reassured; new capital was invested; the economy started growing. So one must hope, and in due course, the Portuguese economy no doubt will grow.

But it is hard to generate growth, and hard to predict when it will happen. Access to capital is generally thought to help, but as already suggested, capital is fickle. In the US, recapitalization of the banks did not lead to lending, much less employment, and growth itself has remained fragile, perhaps too dependent on overseas investment and government spending at home. Moreover, growth, or lack thereof, is often dependent on external factors. Consider, for obvious example, the price of oil.

Growth may certainly be prevented. Disorder and violence can shake confidence, which of course is an issue in many developing countries. Or simple apathy, or rigid regulation that leads to a sense of improbability, can stifle investment, which is an issue in so-called rust belt cities, like Buffalo, NY, where I teach.

In Portugal, two factors seem particularly important to me in thinking about growth. One, already mentioned, is that the population of Portugal, like much of Europe, is aging. The other, also already mentioned, is that Portugal is a great place to be. How will these factors balance out, and when? I do not know. So I think one should be a bit agnostic about growth. Policy should attempt to foster growth, but not be too dependent on achieving it. Like wisdom, growth comes when it, and we, are ready.

But, as with wisdom, one should be ready. Even if the troika's promises of growth are discounted, substantial reform makes sense for Portugal. Why?

First, as mentioned, the status quo is unsustainable. Portugal's economy has not grown in significant fashion in years, and currently is shrinking. Significant institutions are insolvent, or would be without international support. Export is never easy, and certainly is not now. The population is aging. Substantial reform is necessary to preserve current standards.

Second, substantial reform would be more likely to help Portugal grow; the current arrangement has reached its limits. Portugal needs to roll the dice. An analogy may be made to sport: if one is losing the game, one makes adjustments that may not work – but they might!

Third, as already suggested, it reasonably may be hoped that a more flexible Portuguese (and European) economy would not be so vulnerable as the present one has proven to be, or at the very least, would be vulnerable in different ways. That is, the pursuit of stability has revealed substantial systemic risk; addressing that risk requires a more sophisticated understanding of the economic ecosystem than European "stability" offers.

Fourth, a more flexible – robust and dynamic – Portuguese economy will feel different, will offer different opportunities. In particular, it should be able to offer more opportunities to both entrepreneurial and professional people, thereby alleviating brain drain, which might help increase both prosperity and happiness.

Conclusion of Part I. To clarify all of this, Part II of this Letter to Portugal, "Practical Steps Toward a More Flexible Portuguese Economy," will discuss a few specific aspects of both the troika's plan, and the general discourse, with an eye to what "flexibility" might mean for short and medium term economic policy in Portugal.

I realize that my thinking may well sound too naively optimistic, to be blunt, too American. It is true that the United States is a land of incessant self-invention, and other places feel themselves more constrained by historical circumstance. But I also know just enough history to recall that this is not the first time that Portugal has been asked to reinvent itself, and has done so. Although this is neither 1755 nor 1974, the Portuguese do have the historical and cultural resources to do impressive things, now. And I think they will.

PART TWO: PRACTICAL STEPS TOWARD A MORE FLEXIBLE PORTUGUESE ECONOMY

A Veneer of Rationality. One of the interesting things about a debt crisis, as opposed to other economic maladies, is that debt tends to fall due on certain dates, and so the crisis has a schedule. Absent assistance, Portugal's government feared that it would not be able to roll over a sufficient share of the debt falling due on this June 15th, and would consequently face insolvency. The Portuguese government therefore formally asked for assistance from the Troika.

Let me highlight two aspects of the scheduled quality of this crisis. First, the very existence of a schedule reminds us of the importance of time. Crises may unfold quickly, but not instantaneously. Business plans, and reforms generally, are narratives. Sequence matters. So, in considering the transformation of the Portuguese economy, it is important to think about when something can be done, and when it must be done.

Second, the scheduled quality of a debt crisis lends it a veneer of respectability, even rationality. Requests are made by officials; elites make arguments; meetings are held and essays are written. This veneer, however, is only a veneer: a thin covering that covers, and tends to hide, what lies beneath. The fundamental issues at stake in a debt crisis, at least one as large as this one, are issues of social structure, culture, and psychology – we might say history, which moves in mysterious ways. So, throughout this essay, I am trying to keep in mind the fact that existential issues are in play, and discussing such issues may require a certain awkward candor, even lack of politesse.

Moreover, this veneer of bureaucratic rationality comes at a political cost: the more elites appear to be managing this situation (while calling for substantial sacrifices from the populace at large), the more the situation appears to be a power struggle among elites. Precisely because the discourse is conducted in technocratic terms and dominated by the exquisitely educated, the crisis does not appear to be about reconstructing Portuguese markets and so society, which is by definition a populist project, because a market is constituted by its participants, as mentioned in Part One. After technocratic discourse, the market is what people do – the game is what people are actually playing. People tend to ask what are "they" doing to us, when the real question for political economy is what are we going to do, under the new circumstances?

Repay? Restructure? Default? Let me start by confronting the most pressing practical question, and impolitely simply: to what extent should Portugal repay its debt? Interestingly, both a principled socialist position and a principled market capitalist position suggest that Portugal should default. From the left, why should the Portuguese people suffer for the interests of international capitalists? From the right, why should tax money be used to bail out investors who mispriced risk? Such investors should be eliminated from the market, or at least bear the costs of their mistakes – that is how markets work. The intervention of the Troika is moral hazard of the worst sort.

For the short term (this summer at least), acting upon the principled positions of the left and right would be disastrous. To the left, one might point out that insolvency of the government would lead to direct pain to those dependent on government services, or who work for the government. At the same time, insolvency of the government could be expected to lead to collapse of the financial sector for a host of reasons, ranging from the fact that banks hold a great deal of government debt to the fact that a credit rating downgrade of the government would impact the credit rating of Portuguese companies to the fact that many financial institutions do a large share of their business with the government or with government controlled entities. Collapse of the financial sector would severely impact households and businesses . . . people would suffer.

To the right, one might point out much the same, albeit in a different key. Given the centrality of the Portuguese government to key Portuguese institutions, especially banks, the sudden insolvency of such institutions would presumably lead to an almost instant evaporation of liquidity across the economy, immediately followed by a rapid contraction of activity. As unpleasant as moral hazard problems are, an economy seeking equilibrium at radically lower levels of activity is worse.

For those on both the left and right who might be tempted by the idea of default, it bears remembering that Portugal is not Argentina, a large developing country with its own currency, much less Russia. Portugal is a small country that benefits greatly from its participation in a monetary union, the Euro area. The European institutions are deeply intertwined, and least for the present presume the creditworthiness of the Member States. Violating that presumption – precipitously defaulting – would inject substantial uncertainty into the system with regard to the solvency or at least liquidity of key institutions, to the pricing of sovereign debt generally, and to the capability of the institutional machinery of the system as a whole. Such unpleasantness for financial institutions and governments could be expected to have real economic effects throughout Europe, which would envelop Portugal.

The classic argument against defaulting is, of course, the argument from the long term self-interest of the borrower. Simply put, defaulting, thereby proving that one is a bad credit risk, makes it harder to borrow money in the future. Since most modern notions of economic development, to say nothing of the daily operations of most complicated institutions, are based on access to credit, losing one's creditworthiness is not in one's interest. In the case of a government default, the ability of financial organizations, firms and households to access credit often suffers. Illiquidity may spiral into insolvency . . . so the borrower, and especially the sovereign borrower, should scrimp, save, and otherwise suffer in order to repay the lender. Or so lenders like to argue.

How much harder it will be for a given borrower to borrow again, after a default, is difficult to know ex ante. Surely it is possible to overdo arguments from the bond vigilantes, or their friend the confidence fairy: there are worse things than bankruptcy.

Future investors should be able to recognized real opportunities, that is, credit may be reestablished, especially if there is money to be made, and it can be plausibly argued that the borrower has reformed, or perhaps some other form of security can be offered. But the process is likely to be long, unpleasant, and far reaching. In the worst cases, and especially in light of uncertainties, fundamental confidence may be shaken, with potentially disastrous consequences for the real economy. For all these reasons, creditworthiness should not be given up lightly.

More philosophically, the left tends to forget that investors may not be demonized without remorse. To default is to break obligations relied upon by banks, pensions, insurance plans, endowments – institutions that serve people. Sufficient damage to those institutions will hurt the people served by the institutions. Even granting that wealth distribution ought to be more equal, all capital is social capital.

The right also tends to forget that markets are socio-political mechanisms. A badly functioning mechanism, such as the sovereign debt market in Europe, needs to be fixed, not allowed to play itself out to the bitter end. Thus, in the short term, Portugal has no real choice but to proceed much as it has, i.e., to borrow money, accept conditionality, and make good its obligations on June 15th, at a 100 cents to the Euro.

Transitions. Taking the medium term view, however, both the socialist and market capitalist caricatured here have very valid points. Surely a well constructed financial market does not privatize profits and socialize losses? And surely sovereign debt should be priced sensibly, and moral hazard avoided? Moving from Portuguese sovereign debt to the Portuguese economy writ large, as discussed through Part One, surely this is the moment to create a better, more flexible, economy? If this is not our economic policy now, then when?

The debt crisis thus presents us with contradiction: honoring current debt obligations (supporting a systemically vital market) while acknowledging that the market is in dire need of substantial reform (hence the crisis). This contradiction may be framed, narratively, as a transition: how to sustain the present, deeply flawed, market long enough to create a better one?

Such questions are no longer to be addressed in the abstract. Moves have already been made, and the game is in progress. Portugal has already gone to the Troika. As set forth in the MOU, the Troika has begun lending money and imposing conditions, with the express intention of reforming the Portuguese economy. It is conceivable that the MOU works on its terms: reforms are taken; Portugal regains access to the financial markets, which obligingly return to "normal" on schedule; Portugal becomes globally competitive, and grows, all by 2013. Even if such things were to come to pass, however, I would argue that the MOU does not really go far enough in creating a flexible economy for Portugal.

To put matters gently, however, prudence requires consideration of the possibility that the Troika is overly optimistic, and that the objectives of the MOU will not be achieved in the timeframe envisaged. It would therefore be sensible to think about the transformation of the Portuguese economy in more modest, but probably more realistic, fashion.

Fortunately, the MOU provides a useful scheme for understanding the transition from today's economy to a better one. "Success" under the MOU may be achieved in at least four different ways, in increasing order of time and difficulty.

1. In the coming weeks, success means the ability to meet obligations when due, notably the debt of June 15th. This has required substantial effort, but appears to be all but accomplished.

2. Over the next 18-24 months, success means the ability to comply with conditions set forth by the MOU. This looks to be possible, if the new Portuguese government can muster the political will. As noted below, however, this legalistic understanding of success may be vital for Portugal's credibility in international negotiations.

3. Over the next years, a key measure of Portugal's success will be the ability of the government to borrow money on the international financial markets. Before the end of the program in 2014, Portugal must have regained normal access to capital markets, implying that Portugal could issue debt in 2013. As already suggested, this seems very ambitious.

4. Over roughly the same period, Portugal's success will be whether or not Portuguese business is competitive in Europe or globally, and whether Portugal grows. Indeed, the Troika's position seems to be that enhanced competitiveness is a prerequisite for the investment discussed in #3. As discussed in Part One, however, I am rather agnostic about the timing of growth., and certainly do not think it can be a prerequisite for the reestablishment of creditworthiness (though it would be nice).

Access to Capital, Systemic Risk, and the Role of Government. What if Portugal has little or no access to the capital markets in the medium term? When the current package has been spent, will the current crisis be replayed, but at a much higher pitch, and with less room for maneuver?

In such circumstances, Portugal might have to return to the Troika, and ask for some sort of bridge loan. In that event, enthusiastic compliance with the MOU might be a sine qua non for success. In order to argue that the plan set forth in the MOU was flawed. Portugal will have to argue that it complied with the conditions set forth by the Troika. Even if the Portugal's case were found compelling and a bridge loan made, recourse to the Troika is at best a stopgap: Portugal's medium to long term financial plan cannot be to borrow tax dollars from supranational institutions.

Even the stopgap, however, may not be available. While asking for a bridge loan might be a sensible response to the evidently overly ambitious plan set forth in the MOU, asking the Troika for more money is hardly a good option. To state the obvious, financial interventions (rescues) are already very controversial across Europe, and there is no reason to believe that interventions will become politically more popular in a few years.

To make matters worse, Portugal is not the Troika's only, or biggest, problem. The debt problems of other countries in the interim may exhaust the will, or even the funds, to assist Portugal when the money made available under the current package runs out. That is, further assistance from the Troika is politically and economically uncertain.

What we may call the Deauville problem adds a useful wrinkle. At their meeting in Deauville, France, in October of 2010, Germany's Chancellor Merkel and French President Sarkozy declared that private sector involvement would be called for in the context of orderly crisis management, thereby reopening the possibility of sovereign debt restructuring. This would require amendment of the Treaties, to be adopted and ratified before 2013. It has since been clarified that no debt issued prior to 2013, i.e., no presently outstanding debt, would be subject to such restructuring.

From a reformist perspective, the Deauville Declaration presents a serious problem. Consider, by way of analogy, a firm which is distressed and being restructured under the bankruptcy laws. Investors in the restructuring, new money, are generally given priority over earlier investors. Assuming that the firm is worth saving, that is, reorganization is likely to return more than liquidation, then giving new investors a priority is in the interest of the earlier investors, even if they have to take a haircut. One might say, in addition, that early investors did not price risk correctly (as demonstrated by the current insolvency). In contrast, new money is going in with eyes open, and is presumably doing a better job pricing risk. Such potential investors are induced to invest in an inherently risky situation in part by being given higher priority, which lowers their risk somewhat.

Now consider a country, which cannot be liquidated, but which is trying to reform its institutions, and which receives conditional liquidity. Consider Portugal. What would lead new money to invest in such a situation? The situation is uncertain (hence "crisis" and "intervention"). On the way to the world envisaged by the Deauville Declaration, any new investors will have to consider that new sovereign debt will be, by its terms, subject to restructuring, and hence presumably riskier. Thus, the transition makes capital that much harder to raise in reform situations, when it is needed the most.

One possibility is to take a "project finance" approach, that is, to try and lower the burden on the Portuguese state qua state, by moving public services into institutions that control an income stream, which could be used to provide assurance to investors in those institutions. At the same time and conversely, the monetary obligations of the Portuguese government are reduced accordingly. At some point, the core, direct, monetary obligations of the Portuguese government (payroll springs to mind) ought to be sufficiently small vis-a-vis the taxing capacity of the state that investors are comfortable investing.

More generally, access to capital is likely to be enhanced by reducing the centrality of the national government, not as a legislator or more generally, guardian of the public good, but as an economic actor. As it stands now, the government is the hub of the Portuguese economy. As a result, the government is very large, and the government's access to capital and the economy's access to capital are roughly coterminous. If, as may be expected, the government will have more difficulty accessing the financial markets, then the economy needs to develop alternate sources of funding.

At this juncture, it is useful to remember that the government and "the public" are not the same things. The government should not give up its proper role as guardian of the public good, but it need not directly provide most such goods. Many things that the people need can be provided by institutions distinct from the government, and therefore financed without much regard to sovereign debt, election cycles, and the like. Especially once markets are understood as political mechanisms (and this is political economy we are attempting), then public finance need not be the same thing as financing the state.

Begin from the proposition that the well-functioning society affords its citizens certain things. An important question for political economy, then, is which things are to be done by which institutions? The conventional distinction between "public" and "private" tends to obscure this point. Harvard University is a "private" institution, and is certainly not the state (although it is supported by the state in many ways), and fulfills many very socially important, and in that sense "public" functions. But Harvard's assets and liabilities are not part of the federal government's budget (or credit rating). Conversely, when balancing its books, Harvard cannot rely on the privileges enjoyed by the government, namely to tax. Thus the distinction between "public" and "private" does little to resolve questions of public finance.

With this thought in mind, the question of how to finance publicly vital functions (like education) can be approached more creatively, even under the foreseeable constraints of a gradual return to sovereign creditworthiness and the Deauville problem. Enterprises that generate a revenue stream, or collateralizable assets, can and often ought to be financed separately from the state. Conversely, if the government were to shift its obligations to self-funding institution, then government will have fewer obligations vis-à-vis its capacity to tax, and its creditworthiness should improve accordingly.

Recall from Part One that government was the central vector for systemic risk in the present crisis in Portugal. The government's enormous budget, massive payroll, ownership of, or partnership in, a host of businesses, and extensive debt means that the entire economy depends on confidence in the government's solvency. Thus thinking about systemic risk and access to capital over the medium term lead to the same strategy: *Portugal should reduce the centrality of the government as an economic actor*.

Or, to put matters slightly differently: Part One of this essay argued that stability, centralization and conformity had reached their limits as governing norms for the Portuguese economy. The Portuguese should, therefore, turn to flexibility as a way to think about economic policy. This is not merely a normative suggestion on my part, i.e., is not dependent on the political will in the abstract. Part Two of this essay provides a mechanism for the transition to a more flexible economy. The government's need both to provide for the public good and for financing– even assuming that Portugal does not default on its current obligations and complies with the MOU – is likely to lead to the substantial divestment of the Portuguese government from the Portuguese economy.

(Indeed, substantial privatization is part of the MOU itself, albeit for the traditional reasons.)

In light of the ideology of some of my fellow Americans, I should make it clear that I am not arguing for privatization for its own sake. I am certainly not arguing from some sort of neo-liberal, neo-conservative, Chicago school or what have you faith in unbridled capitalism coupled with a paranoid distrust of government. Again, the European social contract is not really up for debate. The question is how can that contract be kept, how can the Portuguese ideal (or something close to it) best be achieved? For reasons discussed, I am arguing for less government participation in the economy as an actor. Conversely, as a matter of political economy, this requires a more robust civil society: more responsible institutions, with more autonomy and their own financing, and therefore, in many cases, more regulatory oversight. Over the long haul, Portugal will be better served by a government that governs more and owns less in a robust, dynamic, and ultimately more reliable, economy.

* * *

What follows is a list of ideas that, taken together, are meant to work together to constitute a more flexible and hence reliable economy. Many of these ideas are in the MOU, albeit considered in terms of fiscal responsibility. This list is by no means exhaustive. There are no doubt other, better ideas. But this listing might provide a useful place to start.

Reduce the centrality of government as an economic actor and foster civil society. The argument, made throughout this essay, that direct government participation in the economy ought to be reduced carries with it a corollary, the nurturing of a well-functioning civil society, institutions to take up the tasks no longer performed by the government.

In cases in which the government owns businesses normally conducted by the private sector – large banks and airlines spring to mind – this is fairly straightforward, although it may need to be done with sensitivity to market conditions in particular cases. It is not even necessary to find a single buyer: the government's equity positions can simply be reduced through stock sales, thereby creating a publicly held company.

Many goods – public utilities, roads, and the like – are both clearly in some sense "public," and are often provided by government. Ensuring that such goods are adequately accessible, sustainably managed, and financed is no small task. Focusing on the problem of finance, however, the positive aspect of many such goods is that they generate revenue streams, and therefore can in principle be financed without recourse to taxation or general sovereign debt. The oft-proposed high speed train between Madrid and Lisbon may or may not make sense, but if built it will generate substantial fee income, which could be used to secure at least part of the financing needed for the project.

Thinking more dramatically, higher education could be financed in a more "American" style, in which students pay for their own education by spending their family's money, borrowing money, or winning scholarships if they are less well off or particularly gifted. These are just ideas, examples, but the general point is that financing the public good is not the same thing as financing the state.

Reduce government debt. Unsurprisingly, the Troika has demanded that government debt be reduced. This is a good idea, not merely for the usual reasons, but because governments in advanced economies worldwide have grown too dependent on debt markets. Particularly in the United States, I think there is a real issue of political irresponsibility here. In an anti-tax and low interest environment, political elites are simply too tempted to borrow money, thereby shielding their policies from the anger of voters.

The discipline of modern finance has tended to make financially sophisticated actors, including governments, overly reliant on debt markets. But debt, with a term, entails moments of decision. Such decisions are not always rational, or may be rational, but politically disastrous anyway. Investors may overreact, capital may flee, may not be rolled over, and the like. Issuing too much debt is thus like giving hostages.

The financial crisis worldwide may be understood as the result of the widespread belief of financial elites in risk management, which prompted such elites to take on too much leverage. The financial crisis demonstrated that risk is far more difficult to manage than was previously thought, for reasons we are still trying to articulate. As a corollary of this newfound appreciation of risk (and the rediscovery of uncertainty), leverage should be reduced accordingly. Simply put, governments and institutions should carry less debt.

Nor is so much debt really necessary. Most of a government's obligations are ongoing and incremental – health, education, and so forth. Such obligations can be funded in the old fashioned way, through taxes. The classic exception to this proposition is war, which generally must be financed through debt. It is true that European integration aims to avoid war. The achievement of peace in Europe makes it that much easier to avoid government assumption of excessive debt.

Finally, and it is difficult to know how strong this effect would be, lowering the supply of government debt, presumably driving up its cost and lowering its yield, might encourage investors to shift capital to other institutions, fostering the more flexible Portuguese economy for which this essay has been arguing.

Those things said, the usual reason for lowering the debt to GDP ratio – preserving access to credit – is not to be taken lightly. Although debt has clearly been abused in recent years, nations, firms and individuals really should preserve access to credit, because it smoothes so much of life.

Share the Pain of Restructuring. There are times – these are times – when markets fail and need to be restructured, and that requires the intervention of government and the spending of public money. That said, in both Europe and the United States there has been a substantial amount of "privatizing profits and socializing losses." And that is unacceptable, except in extraordinary circumstances and on a temporary basis. Business as usual, in a society that aspires to be both democratic and capitalist, means that economic actors are economically viable, without recourse to the taxing power of the state (and ultimately the state's monopoly on legitimate force). And business as usual means that tax dollars are spent in society's interest. Even justified interventions, such as Portugal's rescue package, are thus to be viewed with suspicion.

Banks may argue that the lack of liquidity of their assets has been unpleasant. No doubt, but the fact remains that, under current plans, current investors are made whole. As of this writing, Europe has not allowed sovereign debt default (or restructuring or reprofiling or voluntary restructuring, usw.), but has instead asked the populace of countries receiving assistance to tighten their belts. In short, very little pain has been shared.

Just as it may be in a borrower's interest to repay because it is important to preserve credit worthiness, it maybe in the long term interest of lenders to restructure, because it is important to preserve economic vitality. It is not in creditors' interest to shut down the economies of overleveraged countries. More generally, markets cannot work if people do not participate: confidence and a sense of hope ("mojo"), and therefore a degree of fairness, are indispensible.

Going forward, it may be hoped that collective action clauses will facilitate the restructuring of European debt. I also like the idea of buying distressed debt on the secondary market or other forms of market-based intervention that lock in losses for lenders and minimize moral hazard. I would also argue that Europe will soon need to acknowledge that sovereign debt, like other investment vehicles, should be marked to market. But these are issues of European policy, and so somewhat beyond the scope of this essay.

Member states retain primary authority for the resolution of failed financial institutions. A bank failure is one of the times in which we must accept the lesser of two evils, i.e., that losses will be socialized, and investors (primarily depositors) will be protected with tax money. Bank failure should result, however, in the liquidation of the institution in question. Both the US and Europe have shown insufficient willingness to be tough on failed institutions, meaning failed institutional management.

It bears mentioning, however, that the specific failure most prominent in this crisis, financial institutions buying large amounts of ultimately unsound government debt, hardly qualifies as rash. Government debt is, or heretofore has been, the most conservative of investments. Banks were wrong about this, but so were their regulators.

Foster competitive banking both domestically and internationally. Over 75% of commercial banking (both business and household) in Portugal is controlled by five Portuguese banks, all intimately involved in government affairs. Under such circumstances, not only is a truly competitive banking market unlikely, it exposes banks – and hence the economy as a whole – to the weaknesses of the Portuguese government.

The Portuguese economy's access to capital should not be a function of the Portuguese government's success on the capital markets. So Portugal needs foreign banks, not to buy debt, but to be banks – to make ordinary business and household loans. A larger presence of major banks, doing business in Portugal, might mean that if and when a crisis arose, business and individual access to capital was less threatened.

Interestingly, a more open capital market within Portugal might be reassuring to investors in Portuguese sovereign debt. To make things simple, suppose one has a vineyard, or perhaps a renewable energy project. If the financing is through a European – but not Portuguese – bank, then one might think that, even if the Portuguese government, or financial system, were to run into trouble, it would not affect the operation of the vineyard or the renewable energy project. Presumably, such businesses would continue to pay taxes, thereby helping the government's position. That is, the government's distress, or the distress of some other actor, need not be immediately translated to all other actors. Strength through flexibility.

At the same time, Portuguese financial institutions should increase their current efforts to do business internationally. In particular, Portuguese banks have connections throughout the Lusophone world, as well as elsewhere, especially in Africa.

Encourage entrepreneurship by reforming bankruptcy law. As mentioned, reducing the government's participation directly in the economy, as owner, presumes the establishment of an ecosystem of actors that can do the work society needs. Reducing the government's social profile should mean increasing the profile of businesses and other institutions.

A major obstacle to the establishment of such institutions is personal risk aversion. Simply put, new businesses often fail, leaving debts in their wake. In Portugal and many other countries, such debts are generally the personal responsibility of the founders of the business. In light of the fact that the business just failed, and the debt is presumably compounding interest, such debts are not easily repaid by the founders. Knowing all this, Portuguese are rationally reluctant to form new businesses, to take on risk.

At least as a legal matter, addressing this problem is simple. (As a cultural matter, almost nothing is simple.) Company law, and bankruptcy law, should be understood to limit the liability of founders of companies. In the general case, outside investors in such businesses should expect to lose their investment if the business fails, and not to be able to encumber the lives of the persons who tried. Rephrased, the point of bankruptcy and company law is to encourage reasonable risk taking.

There is no moral problem here. An investor is paid for bearing risk, including the risk of a company's failure. It is therefore important for investors to price risk appropriately. Risky ideas should receive financing at a higher rate, if at all. By the same token, failure to raise capital at a reasonable rate serves as a signal to entrepreneurs that their business model is not convincing, and perhaps needs more work. None of this happens if nobody gets in the game.

Collectively, if people only work for established institutions, it is hard for the society as a whole to innovate, to change, to renew itself. It is hard to grow. In the current circumstances, when new institutions are likely to be needed because the government's capacity to provide service is likely to shrink, it is particularly advisable to encourage people to take a little risk, start something new. The easiest way to do that is to reassure people that if things do not work out – and things often do not work out, often without anybody being at fault – then life will go on.

As suggested in the discussion of sharing the pain, a somewhat looser attitude toward debt collection is in the interest of creditors. Far better to be a banker or other investor in a dynamic business environment, with the inevitable occasional bad loan or what have you, then chase a few basis points in a moribund economy.

Encourage development of business culture through legal reform. The idea that the Portuguese legal system is unbearably slow, and should therefore be reformed, is not new. Of course litigants do not like to spend huge amounts of time and money resolving disputes; this is inefficient in most senses of the word.

That said, the reason legal reform is important for purposes of political economy is quite different. Legal practice, backed by a well functioning legal system, is one of the primary ways that society develops business culture, and in particular, adopts to change. Suppose, for relevant example, one wants to foster technological innovation, much of which is done by people who are simultaneously teachers, researchers, and inventors, operating in a number of institutions. How is intellectual property to be defined, conveyed, commercialized, and otherwise disposed of in this environment? The answer, of course, is a system of contract – a licensing regime. Such regimes are not produced by government activity, but by "private" negotiation, backed by a court system. As this essay has argued throughout, however, markets are never simply private; the collective social practice of licensing provides an environment in which intellectual property can be commercialized, and therefore can attract capital, and therefore can be developed in the first place.

The general point is that courts help societies harness their energies to produce a public tradition (a jurisprudence) which in turn produces the reliability on which economic activity depends. All of this is done with only minimal input from the state, which generally pays only the cost of the court system.

Open to the World. As already suggested, Portuguese society is aging, and demographics impose severe constraints on growth. An obvious way to lower the nation's age – and to provide for an aging population – is to encourage immigration. The United States is, of course, a nation of immigrants. And especially in recent years, in the United States, for all the difficulties, immigration has kept the average age relatively low. And this has made a huge difference to the substantial portion of the population that is aging, and to the economy as a whole.

Especially in comparison with other European countries, many of which fear immigration, Portugal has a long history of immigration, emigration, and return. This history should serve as the basis for a renewed commitment to mobility, in an effort to create a more dynamic labor market. The 16th century will not return, but Portugal should revitalize its conception of itself as a nation of wayfarers and adventurers, welcoming workers from elsewhere, and trading widely.

International competitiveness may be hindered because of weaknesses in education. My perception is that in Portugal, as in many societies, this is not a problem for the elite, but is a problem for the broad managerial/entrepreneurial/skilled classes. Particular attention should be paid to instruction in English, the language of international commerce. While Portuguese elites speak English very well, the question is the extent to which the Portuguese can do business in the language. Insofar as Portugal is serious about revitalizing its export businesses, English competence will be useful.

Strengthen the European conversation. The European response to this crisis continues to be too optimistic. Fundamental difficulties in the European financial architecture have not been confronted. The official line seems to be that the design of the EMU was basically sound, but there have been a few problems with implementation. Rather more technically, the assumption seems to be that this time, fiscal responsibility among Member States like Portugal will be enforced, and that therefore debt spreads will be very, very narrow. The genie will return to his bottle. Indeed.

It seems far more likely that, for the foreseeable future, sovereign debt – and more broadly, development capital – will be more expensive in Portugal than it is in Germany, for obvious example. This is not an altogether a bad thing. Portugal is a different country, with its own problems and difficulties and opportunities. The structural question confronting those who care about the European project is how to deal with the fact that differences will emerge among member state economies, for all the obvious reasons – history, culture, demographics, democratic fortunes, and so forth. Addressing that question is a project for another day; this essay has gone on quite long enough.

The Portuguese should remember, however, that they have much to offer Europe. Portugal should play an important role in the conversation through which Europe will learn to accommodate, rather than deny, its structural differences. To speak confidently in that conversation, however, Portugal needs to attend to its own credibility (creditworthiness in another sense).

Portugal first of all, and others in due course, need to know that the nation is not merely acted upon by the Troika and the creditor nations of northern Europe. Portugal is building new markets, a new political economy, and so renewing itself. That is, this could be a time of which to be proud. Or so it should be.

Conclusion. These are just ideas, for whatever they may be worth. Some of these ideas are probably not workable, and as said, there are no doubt other ideas, maybe better. But the political economy of Portugal, and by extension, the Euro area, that I am trying to suggest is of a more flexible structure, composed of more autonomous entities, in which government is a less dominant player, and therefore, sovereign debt is less of a vector for systemic risk. Spatially, I hope to see in Portugal, and in Europe generally, more net arrangements, and fewer hub-and-spoke arrangements, of socially significant institutions.

A richer network of businesses and other more autonomous entities might be expected to pay taxes, and in due course, might be expected to grow. In order to finance their growth, such institutions would be able to seek capital from a number of sources apart from the national government. Failed enterprises would be liquidated without excessive regret (not everything works), making room for new establishments. Confidence would be restored in a government that had fewer direct obligations, a thriving tax base, and issued debt in prudent amounts.

The picture that emerges is of an old country with a newly diversified, robust, and dynamic economy, with ties to Europe and to much of the rest of the world, too. Which seems historically fitting, at least to this sympathetic outsider who is honored to be asked. Obrigado.

END