Portugal needs stronger investment to maintain growth and improve living standards

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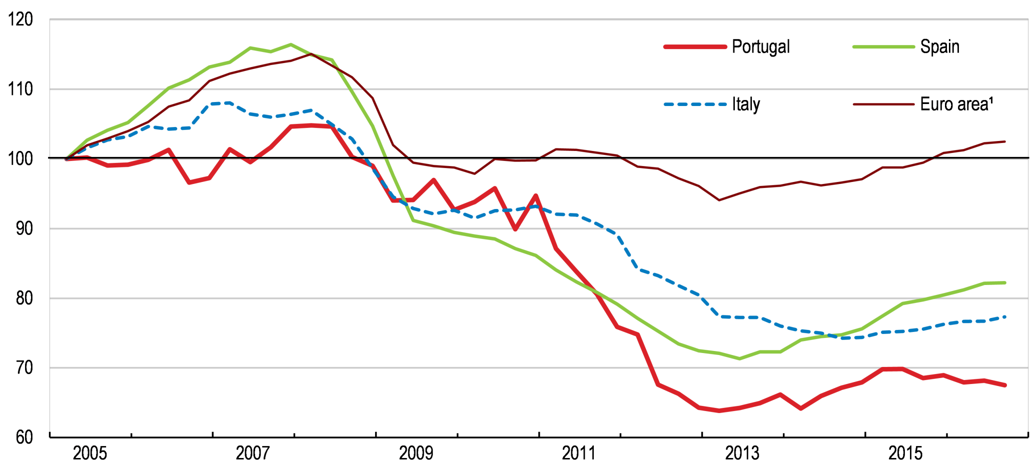
Portugal's economy has successfully recovered from the strong recession that lasted until 2014. Nonetheless, the economy's still low investment, which has declined far more than in other Euro area countries, remains a source of concern (Figure 1). Since 2012, investment has hardly exceeded the depreciation of the existing capital stock, meaning that growth of the productive capital stock has almost stalled. This is one reason behind the low potential growth of the Portuguese economy, which the OECD currently puts below 0.5%. Without stronger investment, growth performance is bound to decline to such low levels over the next years.

Figure 1. Total investment
Volume, index 2005 Q1 = 100



1. Euro area countries that are also OECD members (including Latvia).

Source : OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database) and INE (2016), "Main Economic Indicators", *National Accounts Tables* , Instituto Nacional de Estatística.

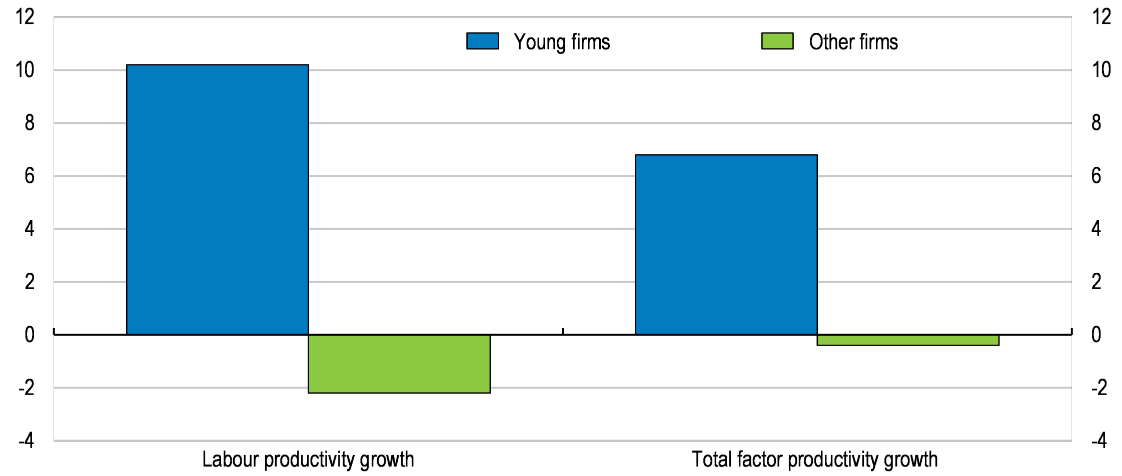
Raising investment also matters for wage and productivity developments. Low investment limits the growth of labour productivity, which represents the wage increases that Portuguese workers can pocket without deteriorating the competitiveness of their companies.

More investment is also needed to support the substantial structural change that the Portuguese economy is undergoing. After many years of credit-fuelled expansion of the non-tradable sector, there have been encouraging signs of a reversal towards tradable sectors in recent years, as illustrated by the significant increase in exports. But building on this progress will not be possible without stronger investment in tradable sectors.

Start-ups and young firms are playing a crucial role in this restructuring process. A remarkable 16% of goods exports originated from young exporters in 2014 (Bank of Portugal, 2016). Young firms are also important for productivity: firm level analysis from a census of Portuguese firms suggests that new market entrants have stronger productivity growth than more mature firms, both with respect to labour productivity and multi-factor productivity (Figure 2). They also create three times more jobs than other firms, accounting for almost half the jobs created (Criscuolo et al, 2014).

Figure 2. Young firms experience faster productivity growth

Average annual productivity growth, per cent, 2006-11[1]



1. Young firms are defined as those aged five years-old or less.

Source : OECD calculations based on data from Integrated System of Business Accounts (*Sistema Integrado de Contas* , SCIE).

But for young firms to prosper, it is important that they get access to finance for their investment needs and that the overall framework conditions are conducive to their entry and growth. Indeed, there is some evidence that the rise of new firms among exporters is losing momentum (Bank of Portugal, 2016). This underlines the need for further improvements in policies.

For example, cleaning up large amounts of non-performing legacy loans on the balance sheets of Portuguese banks is crucial for freeing up funds that stronger firms require to finance investment. In a recent survey by the European Central Bank on SME financing, Portuguese respondents had the second highest incidence of mentioning access to finance as an obstacle, higher than the EU average. Dealing with non-performing loans will require much more decisive policy action than in the past, both with respect to bank supervision and the development of secondary markets for distressed debt.

Given that a large share of Portugal's distressed assets are loans to corporate borrowers, well-working insolvency frameworks are crucial to restructure companies that are still viable and to allow a speedy recovery of non-viable companies' assets before they lose value. Portugal has taken important steps to overhaul its corporate insolvency and restructuring framework. However, differences between the rules and their actual implementation persist.

Access to finance is not the only obstacle to higher investment. Even where firms could finance an investment project, they may prefer to hold off because the expected returns are not sufficiently attractive. Weak demand has been a drag on investment in recent years. That's why it is important to pursue prudent macro-economic policies so as not to jeopardise the recovery of the economy. But further supply-side measures are also crucial. Structural reforms that reduce the cost of doing business in Portugal could make more potential investment projects worthwhile.

Reforms in areas such as regulation, the judicial system, services sectors including utilities and the labour market have led to impressive improvements in historical comparison. However, as discussed in the recently released **OECD Economic Survey of Portugal**, the reform momentum has slowed down visibly since the end of the external assistance programme, and reform implementation has fallen short of initial ambitions in several key areas. In some areas, much has changed, for example in labour markets, although more could be done. In other areas, such as product market reforms and the regulation of non-tradable sectors, there is scope for further progress, particularly with respect to implementation. Some of Portugal's rules and institutional features can act as implicit barriers to firm entry and post-entry growth, and should be subjected to a critical review in light of the loss of momentum in the rise of new firms.

References

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