The Portuguese Experience with the Euro – Relevance for New EU Member Countries[*]

Doświadczenie Portugalii we wprowadzaniu euro i jego znaczenie dla nowych członków UE

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Abstract

In the years leading to EMU, the Portuguese economy experienced robust growth, lower inflation and reduced budget deficits, allowing the country to meet the Maastricht criteria and participate in EMU.

A few years after the adoption of the euro, this scenario changed and the apparent success story revealed a more disappointing outcome. For several years, output growth has been subdued, fiscal performance deteriorated, and, what could initially appear a 'benign' current account deficit, attributed to the convergence process, seems now the result of weak competitiveness, due to increased wages and low productivity.

This paper reviews the Portuguese experience with the euro and analyses how EMU may have affected economic performance. It also discusses whether the Portuguese experience can provide any insights for new EU Member Countries, now in a process leading to the adoption of the euro.

Keywords: monetary union, monetary policy, exchange rate policy, Portugal

JEL: E42, E58, F36

Streszczenie

W okresie poprzedzającym przystąpienie Portugalii do Unii Gospodarczej i Walutowej (UGW) gospodarkę portugalską cechowały: prężny rozwój, niższa inflacja i zredukowane deficyty budżetowe, co pozwoliło krajowi wypełnić kryteria z Maastricht i uczestniczyć w UGW.

Kilka lat po przyjęciu euro sytuacja się zmieniła, a pozorny sukces ukazał swoje słabe strony. Przez kilka lat wzrost gospodarczy był niski, wyniki polityki fiskalnej uległy pogorszeniu, a początkowo „korzystny" – przypisywany procesowi konwergencji – deficyt na rachunku bieżącym obecnie wydaje się rezultatem niskiej konkurencyjności, spowodowanej rosnącymi płacami i niską wydajnością pracy.

W artykule opisano doświadczenia Portugalii we wprowadzaniu euro oraz przeanalizowano możliwy wpływ UGW na wyniki gospodarcze kraju. Omówiono też kwestię, czy doświadczenie to da wyobrażenie o zachodzących zjawiskach nowym krajom członkowskim UE, które są na drodze prowadzącej do przyjęcia wspólnej waluty.

Słowa kluczowe: unia walutowa, polityka pieniężna, polityka kursowa, Portugalia

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Table 1. *Economic indicators, 1995-2000*

Economic indicators	1995	1996	1997	1998	1999	2000
	real change in %					
Real GDP	4.3	3.6	4.2	4.7	3.9	3.9
Domestic demand	4.1	3.5	5.5	7.0	5.8	3.3
Private consumption	0.6	3.3	3.6	5.3	5.2	3.7
Gross fixed Investment	6.6	5.6	14.3	11.7	6.2	3.5
Exports	8.8	5.8	6.2	8.5	3,0	8.4
Imports	7.4	5.1	9.8	14.2	8.6	5.3
	in % of GDP					
Current account deficit	-3.5	-4.2	-5.9	-7,0	-8.5	-10.2
Budget deficit (excl. one-off measures)	-5.5	-4.8	-4.0	-3.2	-2.7	-3.2
Structural budget balance	–	–	-2.4	-2.7	-2.9	-4.1
	in %					
Unemployment rate	7.3	7.3	6.8	4.9	4.4	3.9

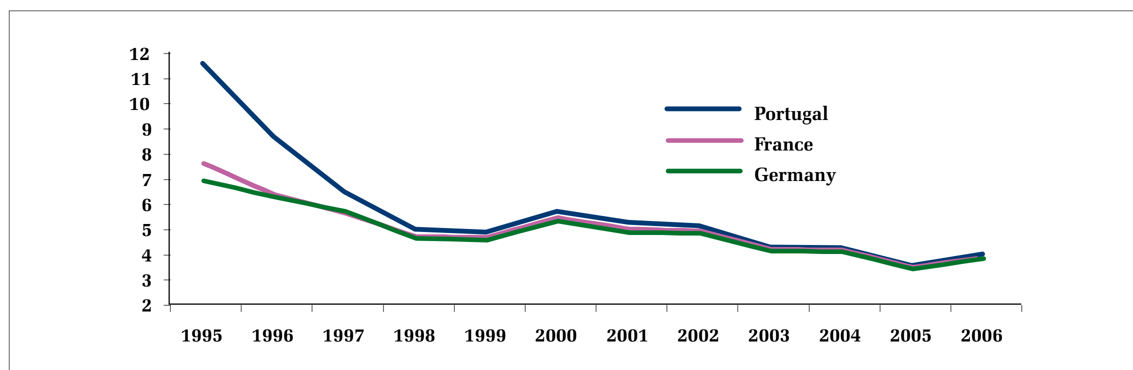
Source: Banco de Portugal, European Comission, IMF.

1. Portugal's economic performance in the years leading to EMU and afterwards

In the mid-1990s, the Portuguese economy was characterised by robust growth, supported by growing productivity and domestic demand. Successful reforms and stabilisation policies, pursued since the time when Portugal joined the European Community in 1986, and the prospect of euro adoption provided an anchor for expectations, which allowed the reduction of inflation and interest rates to historically low levels. The decline in interest rates and an easier access to financing, due to financial liberalisation and increased competition in the banking system, led to the strong household credit growth and to a corresponding decline in private savings (private sector bank indebtedness, starting from a low level, reached 124% of disposable income in 2006). As households adjusted to the fall in interest rates, private consumption expanded. Household credit has also helped finance the boom in housing. Reflecting favourable expectations and the easing of financing conditions, domestic investment also grew. The dynamic economic activity led to a rapid increase in employment (mostly in fixed term contracts), which resulted in the progressive decline of the unemployment rate, from over 7% in 1995 to 4% in 2000, a level considerably lower than the average of the euro area. A relatively tight labour market contributed to wage increases, which further fuelled the demand-led growth. These developments allowed a significant progress in the convergence of real income levels towards the EC average: GDP per capita in PPS, which stood at around 57% of the EC average at the time of accession, increased to almost 75% in 1999.

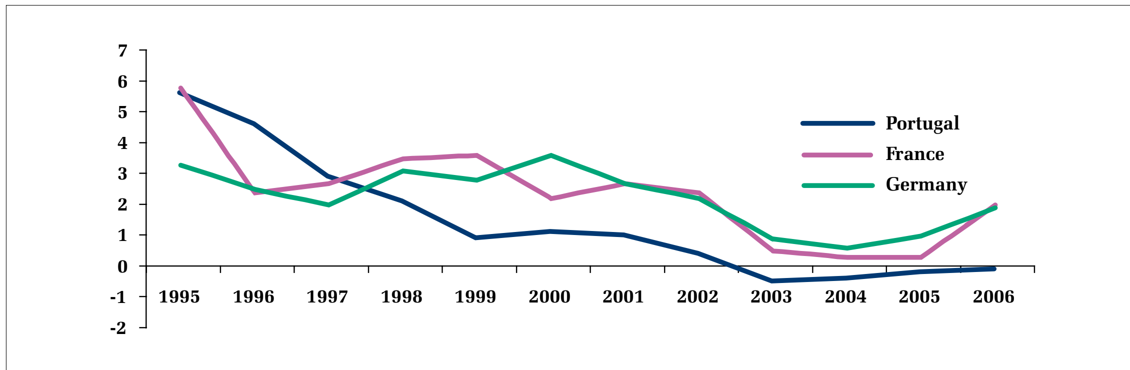
The good economic performance was matched by an improvement in the fiscal accounts, as the fiscal deficit (excluding one-off measures) was reduced from 5.5% of GDP in 1995 to 2.7% in 1999. However, rather than reflecting a strong consolidation effort, this was more the result of increased revenues due to the buoyant economic activity and of reduced debt servicing costs, as interest rates fell. In fact, government current expenditures remained broadly unchanged, and more

Figure 1. *Nominal long-term interest rates, 1995-2006*



Source: EU Commission.

Figure 2. *Real short-term interest rates*, 1995-2006*



* Nominal interest rates minus inflation rate

Source: EU Commission.

recent data show that the cyclically adjusted balance has actually deteriorated throughout that period.

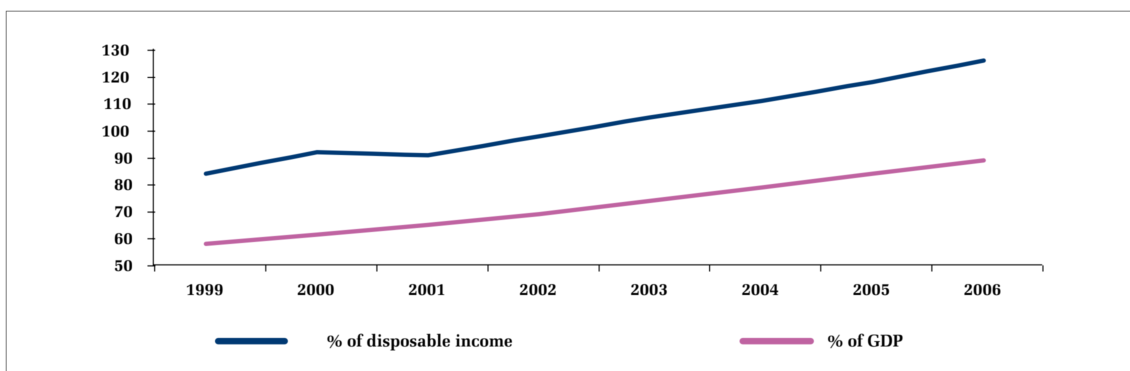
The expansion of domestic demand was accompanied by the rapid widening of the current account deficit, which deteriorated from around 3% in 1995 to a deficit of more than 10% of GDP in 2000. To some extent, the growing external imbalance could be seen as the result of a successful catching-up process, reflecting a higher investment rate, enhanced financial integration and the easing of liquidity constraints, all leading to an increase in the level of imports. However, other factors also contributed to the deterioration of the current account, namely expansionary policies and wage increases, well in excess of productivity gains, leading to rising unit labour costs and to persistent inflation differentials with the euro area. As such, the current account deficit became more a reflex of lower national savings, as consumption, fuelled by strong credit growth expanded faster than income, rather than growing investment, which was mostly directed to housing and the construction sector, with limited effects on future export capacity.[1]

[1] This fact may explain the relatively modest increase in real estate prices in Portugal, compared to other EU countries, which also experienced a credit boom.

Until 2000, the depreciation of the euro contributed to offset the effect of domestic prices and unit labour cost increases on the real exchange rate, and when the real exchange rate started to appreciate this was initially viewed as an endogenous response to the real convergence process. The fact that exports were also growing fast, alleviated concerns about a deterioration of competitiveness. Furthermore, foreign direct investment contributed, for some time, to finance current account deficits, which, together with the euro area membership, contributed to reduce concerns about its sustainability. The fact that in a monetary union the balance of payments is financed in a country's own currency implies that current account deficits are merely the result of private agents' borrowing requirements, whereby the greater financial integration allows a lower correlation between domestic savings and investment (Blanchard, Giavazzi 2002).

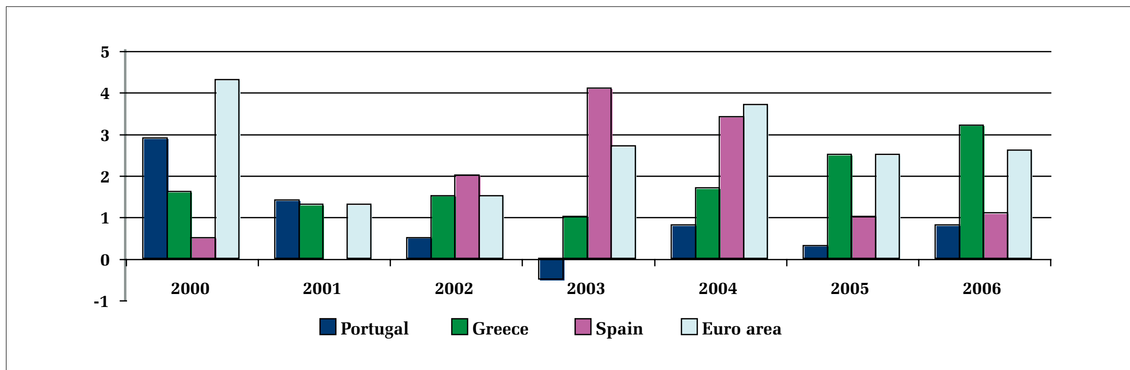
By the turn of the century, it became apparent that the demand-led growth, accompanied by growing imbalances and, without the needed additional reforms to enhance the economy's productive capacity, could not be sustainable over the long run when the economy reached full employment. The downturn of economic

Figure 3. *Household debt, 1999-2006*



Source: IMF.

Figure 4. *Labour productivity, 2000-2006*



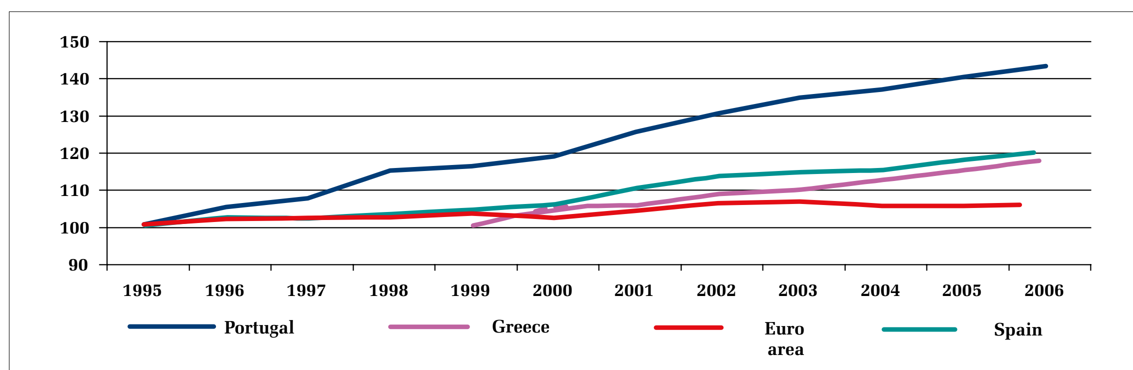
Source: IMF.

activity was also precipitated by adverse external shocks, such as the weakened external demand, as EU growth fell, and an increased competition in world trade in the traditional sectors of Portuguese exports, such as textiles and footwear. This greater competition was due to the EU integration of Eastern European countries, to WTO trade liberalization and to the depreciation of some Asian currencies in the wake of the Asian crises of 1997–1998. As households adjusted to high indebtedness levels, domestic consumption growth declined. Reflecting slower demand, declining profits and unfavourable expectations, investment began to fall in 2002 and continued thereafter (the reduction of investment reached more than 15% in cumulative terms in 2006). As a result, real GDP growth started to decline in 2001 and by 2003 the economy was in recession.

Despite lower growth and investment, the current account did not improve much, as the effect of lower domestic demand on the current account deficit was offset by that of higher unit labour costs and by the real exchange rate appreciation. The sharp appreciation of the euro, starting in 2002, added to these effects. Lower productivity growth, due to insufficient structural reforms aimed at addressing rigidities in product and labour markets, increasingly replaced the role of excessive wage increases as the main cause of the increase in unit labour costs. As a result, the weak export growth, also evidenced by the continued loss of market shares, kept the current account deficit high. A Constant Market Share analysis of the Portuguese exports over the period 1992–2004 (see IMF 2006) attributes the bulk of export market loss to the deterioration of competitiveness (as opposed to other effects, such as global demand, commodity composition or market distribution[2]). According to this analysis, the loss of market shares (in volumes) was even more pronounced before the adoption of the euro, whereas the more moderate pace of the decline afterwards suggests a substantial compression of export profit margins, with a resulting negative impact on investment and employment in the tradable sector. These developments may also have led to a progressive shift of the economic activity from the tradable to the non-tradable sector, with an additional negative impact on productivity. The current account became increasingly financed by rising net foreign liabilities of the banking sector, as FDI decreased.

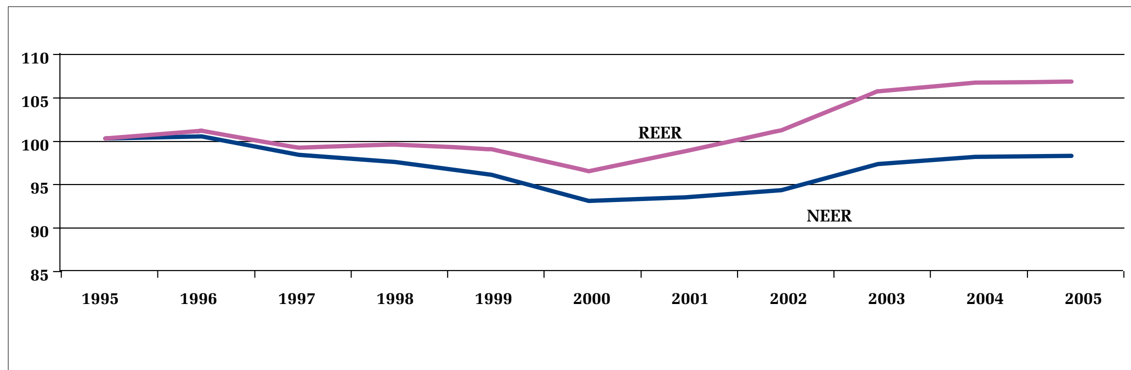
[2] These effects indicate, respectively, the part of the export growth that is due to the expansion of overall world trade, or to the concentration on products or distribution to markets with different demand growth than the global average.

Figure 5. *Unit Labour Costs, 1995-2006 (1995 = 100)*



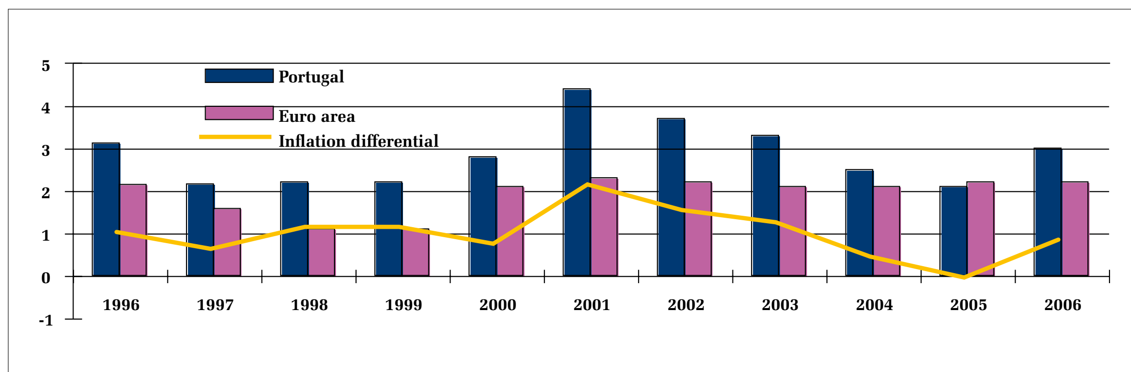
Source: IMF, Eurostat.

Figure 6. *Exchange rates, 1995-2005*



Source: IMF.

Figure 7. *Inflation rates, 1996-2006*



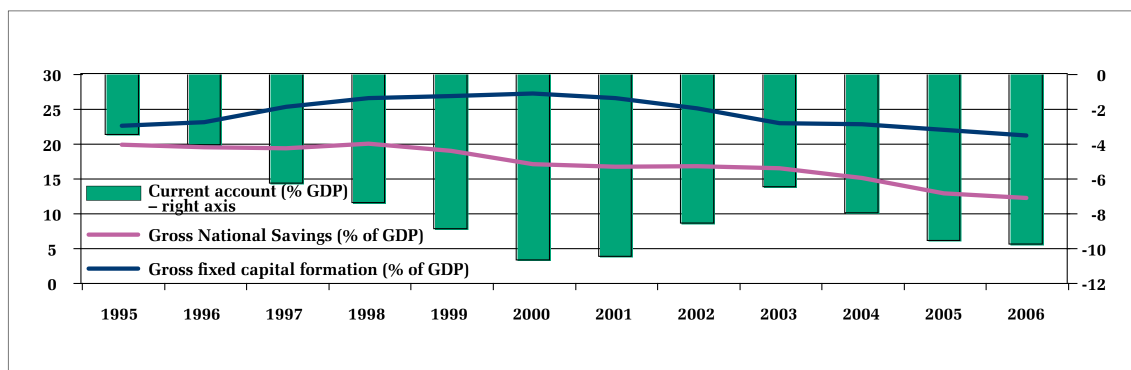
Source: Banco de Portugal, IMF.

The most recent data, however, give rise to greater optimism, as evidenced by the robust export growth since 2006 and by the higher GDP growth rate, albeit still lower than the EU average. Even though it may be too early to reach definitive conclusions concerning the sustainability of these developments, the fact that they were accompanied by some modest increase in productivity, some change in the structure of exports toward more technology intensive goods, a significant fiscal consolidation effort and some improvement in structural reforms, in particular in the area of social security, are good signs.

Nevertheless, the Portuguese growth rate has been lower than that of the euro area since 2002, reversing the initial process of real convergence.[3] Inflation has

[3] It should be noted that the series for GDP per capita in PPS has a break in 2003, due to a change in the methodology used in the computation of rents, which prevents a quantification of the evolution of real convergence for a large period of time (see also Figure 11).

Figure 8. *Savings - investment gap, 1995-2006*



Source: EU Commission.

Table 2. *Economic indicators, 2001-2006*

Economic Indicators	2001	2002	2003	2004	2005	2006
	real change in %					
Real GDP	2.0	0.8	-0.8	1.3	0.5	1.3
Domestic demand	1.7	0.1	-2.0	2.3	0.8	0.2
Private consumption	1.3	1.3	-0.2	2.7	2.1	1.1
Gross fixed Investment	1,0	-3.5	-7.4	0.3	-3.1	-2.0
Exports	1.8	1.4	3.9	4.8	1.6	9.1
Imports	0.9	-0.7	-0.9	7.0	2.2	4.2
	in % of GDP					
Current account deficit	-9.9	-8.1	-6.1	-7.7	-9.7	-9.5
Budget deficit (excl. one-off measures)	-4.3	-4.2	-5.2	-5.4	-6.1	-3.9
Structural budget balance	-5.4	-5.2	-5.1	-5.1	-5.4	
	in %					
Unemployment rate	4.0	5.0	6.3	6.7	7.6	7.7

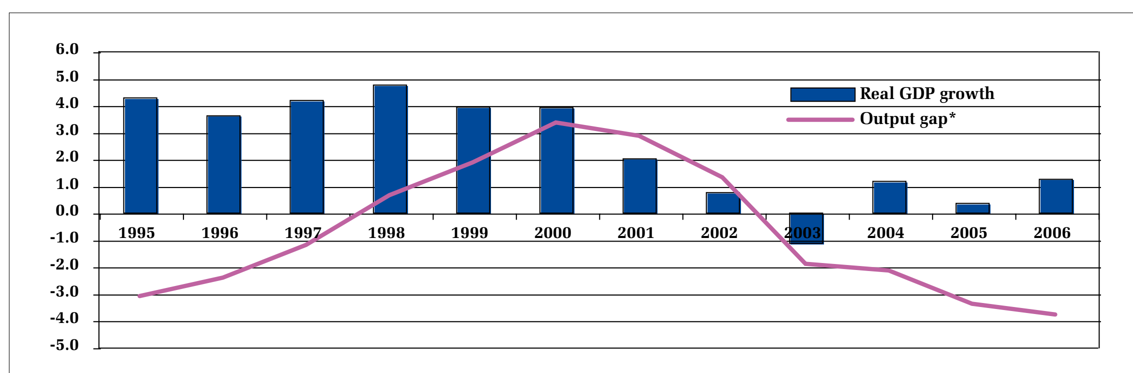
Source: Banco de Portugal, European Comission, IMF.

been, most of the time, slightly higher than that of the euro area. In addition, as fiscal performance continued to deteriorate until 2005, Portugal was, until recently, in a situation of excessive deficit procedure.

Could different policies have prevented this outcome? To some extent, the slowdown in economic activity reflects the adjustment of highly indebted economic agents following a period of demand-led growth caused by a credit boom. In addition, recent Portuguese economic performance was also affected by negative external shocks stemming from lower external demand and increased competition in trade. However, in retrospect it seems clear that less expansionary fiscal and income policies and structural reforms aimed at enhancing economic efficiency and expanding potential output could have minimised the emergence of domestic and external imbalances and increased the resilience of the economy to shocks. Even though extensive reforms were implemented in the late 1980s and early 1990s, leading to the privatisation of the banking system and the liberalisation of capital movements, reforms proceeded at a more moderate pace afterwards. Some progress was made in infrastructure, particularly roads and motorways, mostly financed by EU funds, but insufficient measures were taken to enhance competition and efficiency in product and labour markets and in other important areas, such as the public administration, education and the legal system. These reforms would have been easier to implement in a situation of high economic growth, and, to some extent, this momentum has been lost.

However, in the late 1990s it may not have been so apparent that policies were conducive to economic overheating. Even though a number of indicators could have pointed to an advanced cyclical position (such as low unemployment rate, rising wages and unit labour costs, inflation differential with the euro area, rapid private sector credit growth) available data concerning traditional measures of output gap suggested no significant deviation from potential output. As pointed out in Abreu (2006), contemporaneous potential output growth estimations were much more optimistic than subsequent revised estimations for the same year (for example, the output gap for 1998 estimated at the time was -0.3% of GDP, compared to

Figure 9. *Real GDP growth and output gap, 1995-2006*



* Deviations of actual GDP from potential GDP as a % of potential GDP

Source: OECD.

0.9% estimated in 2006). This overestimation of the level of potential output, given available forecasts, also led to underestimated cyclically-adjusted budget deficits. As such, what at the time seemed like a fiscal consolidation effort, revealed a more expansionary fiscal stance, once more accurate estimations of potential output became available. In addition, other indicators, such as inflation differentials, could reflect real income and productivity convergence, and robust economic growth justified an increasing current account deficit and disguised any shortcomings concerning the competitiveness of exports.

According to Blanchard (2006), the likely scenario that Portugal must face today, in the absence of policy changes, is one of competitive disinflation: a period of sustained high unemployment leading to lower nominal wage growth until relative unit labour costs have decreased, competitiveness is improved, the current account deficit reduced and demand and output recovered. This can be a lengthy process, especially if rigidities in labour markets prevent the adjustment of real and nominal wages, for a given unemployment gap. In order to alleviate the unemployment costs of the adjustment two policy choices are suggested in the paper: (i) to promote a sustained increase in productivity growth through structural reforms, (ii) or a decrease in nominal wages coordinated with a tight fiscal policy. Higher productivity would imply higher growth and, as long as it is not fully offset by wage increases, would allow an improvement in competitiveness. However, as productivity is not likely to increase overnight, the paper suggests that a faster restoration of competitiveness could be obtained with a (substantial) decrease in nominal wages. This option, although politically more difficult, would have similar effects as a nominal exchange rate depreciation, in terms of the implied decrease in real consumption wages and the increase in the relative price of tradable goods. However, even though wage moderation is needed, it seems unlikely that a reduction of nominal wages would contribute to a sustained improvement in competitiveness or to the convergence of real income levels to EU standards. Furthermore, relying mainly on lower wages to restore competitiveness could fail to provide adequate incentives for exporters and policymakers to try to foster productivity growth through greater efficiency, innovation and the removal of distortions which presently constrain growth.

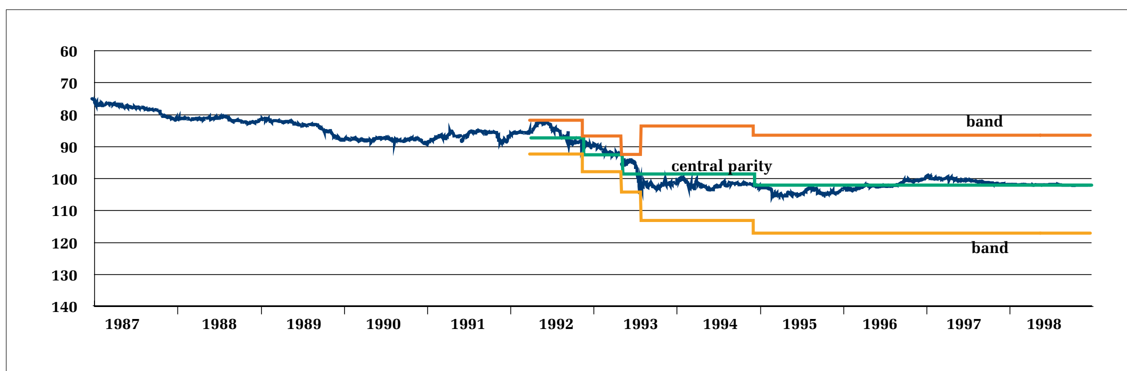
2. The impact of EMU in Portuguese economic developments

A monetary union precludes the use, by a single country, of the exchange rate as an adjusting mechanism in the event of exogenous shocks and of balance of payment imbalances. As such, the burden of adjustment must rely on other channels, namely price and wage flexibility and fiscal policy. When considering the impact of joining a monetary union, the costs of losing the autonomy of monetary policy are usually weighted against the benefits derived by it: reduced costs and currency risks associated with trade and investment in the monetary union, and, depending on the previous situation, greater financial stability and credibility of monetary policy. The conditions under which abandoning monetary and exchange rate policies might give rise to net benefits for a country have been extensively debated in the literature on Optimal Currency Areas (OCA). Generally, these conditions relate to the likelihood of a larger proportion of common rather than specific exogenous shocks and to the capacity to adjust to shocks without monetary policy (through wage and price flexibility, labour mobility, fiscal policy, etc). However, while an important reference point, the use of OCA criteria as a pre-determinant for a monetary union has decreased over time, and, in fact, has never provided a strong case for EMU (some heterogeneity among countries makes them prone to asymmetric shocks, rigidities in wages and prices constrain adjustment to new economic conditions, and labour mobility is low). There are several reasons for the diminishing importance of these criteria. The greater worldwide financial integration, and the enhanced capacity of inter-temporal consumption smoothing implied by it, allows countries to better insulate against a country specific shock. Another problem with the relevance of traditional OCA criteria as a precondition for a monetary union relates to their possible endogeneity: changes occurring after joining a monetary union may contribute to make the economies less vulnerable or more adaptable to asymmetric shocks. These can be attributed, for example, to a greater degree of intraindustry trade (Frankel, Rose, 1996) or to institutional changes associated with a regime shift, namely, greater credibility of monetary policy (Currie 1992; 1997).

As the existence of EMU makes it possible to analyse its impact *ex post,* there is a growing volume of empirical studies, mostly focusing on gains from trade, which generally find that the euro had a positive effect, although the exact measure is subject to variability. As pointed out in Schadler et. al. (2005), an important drawback of most models is the fact that, being based on reduced-form equations, they lack clear structural foundations as to by which channels the effects from a currency union occur.

A possible way to assess the costs that abandoning the exchange rate policy represent for Portugal consists in analysing the importance of the exchange rate as an adjustment tool, prior to EMU. In this context, it is important to recognise that in many ways the Portuguese participation in a monetary union does not consist in a drastic departure from the orientation of monetary and exchange rate policies pursued until then. It rather

Figure 10. *Exchange rate: escudo vs. Deutsche mark, 1987-1998*



Source: Banco de Portugal.

represents a final step in the process of economic and financial stabilisation, which started around the time of EC accession and led to the adoption of the euro in 1999.

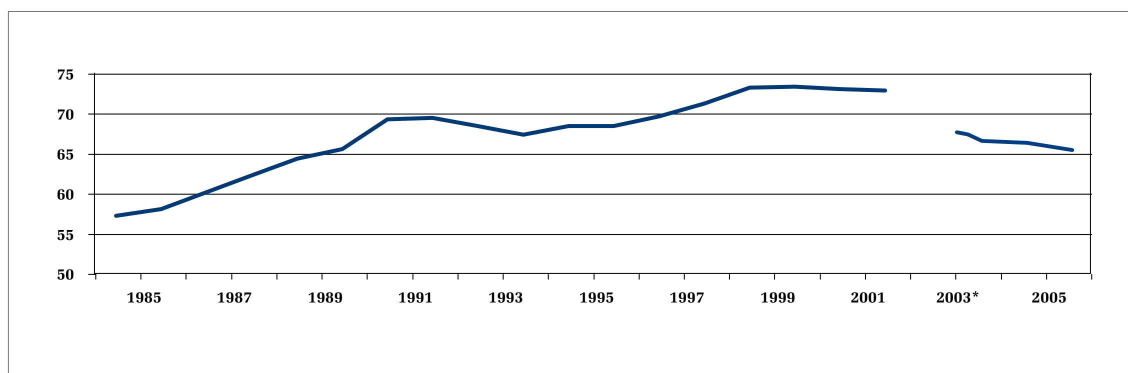
When Portugal joined the European Community in 1986, the inflation rate stood at almost 20%, representing a differential of about 14% with the EC average, and real per capita income barely surpassed half of EC average. At that time, the exchange rate regime consisted of a crawling peg entailing monthly and announced devaluations of the currency, aimed at preserving export competitiveness. The crawling peg regime had been introduced in 1977 in the context of balance of payments difficulties, which led to the negotiation of stabilisation agreements with the IMF in 1978 and 1983, and, at that time, it proved a useful instrument for restoring the sustainability of the current account following these crises. However, as for most small open economies, the pass-through effect of exchange rates on domestic prices was large and the implied vicious circle of devaluation-inflation became detrimental to economic stability and growth when the balance of payments became no longer a pressing problem (Abreu 2001[4]). This scenario made policymakers aware that greater nominal exchange rate stability was needed for achieving macroeconomic stability, which was considered a requirement for the convergence of real income toward EU levels. From then on, disinflation became the main goal of economic policy and, consistent with this objective, the exchange rate policy became progressively less accommodating. The exchange rate devaluation no longer provided full compensation for inflation differentials, even though the crawling peg was maintained for some time. This new policy stance was met initially with considerable success in inflation reduction. However, the implementation of a restricted monetary policy combined with a tightly managed and, therefore, highly predictable exchange rate policy, in an environment of gradual liberalisation of capital movements, triggered a substantial amount of capital inflows, which severely complicated the management of monetary policy. In face of these difficulties, the crawling peg regime was abandoned in October 1990, and a monetary policy strategy based on exchange rate stability as an intermediate target to achieve price stability was progressively adopted. Initially, the exchange rate was targeted against a basket of five ERM currencies, also with the aim of preparing for future ERM participation.

The escudo joined the ERM in April 1992 with a fluctuation band of 6%. The first year of ERM participation coincided with a period of overall turmoil in the system, in the wake of the Danish referendum on the Maastricht Treaty, leading to the widening of the fluctuation bands to 15% in August 1993. The central parity of the escudo was devalued three times within the ERM.[5] As these devaluations occurred in periods of general turbulence and were introduced in the context of realignments requested by the Spanish authorities, the credibility of the Portuguese commitment toward exchange rate and price stability was not greatly affected. In fact, the central bank did not make use of the room of manoeuvre provided by the enlarged ERM bands, and since mid 1993 to 1998, the escudo was relatively stable, despite the last devaluation of its central parity in 1994. The introduction of some exchange rate risk, within the limits provided by the ERM, helped minimise the earlier problems concerning the control and absorption of excessive capital inflows, and the exchange rate stability anchored inflation expectations and allowed the continuous decline in inflation which in 1997 reached 2%, a level broadly compatible with price stability. This allowed a substantial reduction in nominal interest rates and relative risk premia, which contributed to the improvement of budgetary accounts and to the establishment of a more adequate environment for investment and growth.

[4] See also Abreu (2003; 2005), for an analysis of exchange rate and monetary policy in Portugal before the adoption of the euro.

[5] The first realignment of 6% occurred in November 1992. It was followed by another of 6.5% in May 1993 and the last one, in the aftermath of the Mexican crisis, of 3.5% in December 1994.

Figure 11. *GDP per capita PPS, 1985-2006 (EU15 = 100)*



* Break in series

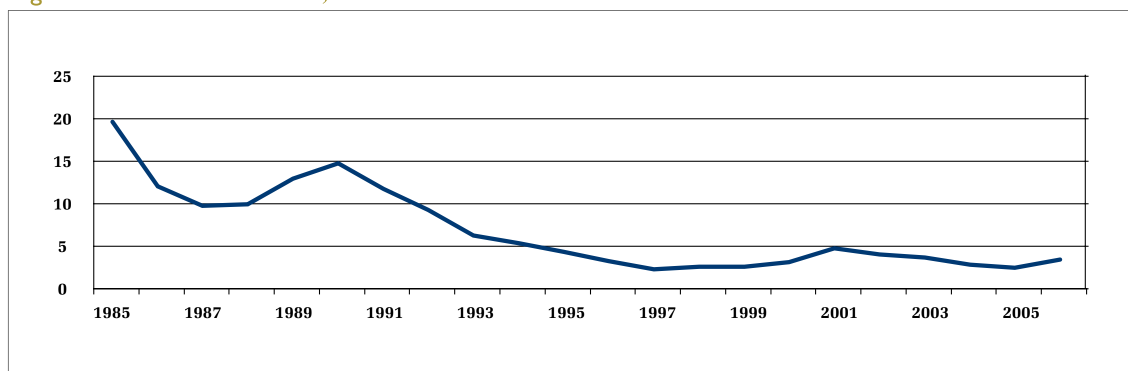
Source: European Commission.

These favourable developments, leading to EMU accession in 1999, are attributable, not only, to the exchange rate regime, but also to a combination of other policies and reforms implemented in an appropriate sequence, since the late 1980s. Among these are: the implementation of an indirect market-based management of monetary policy, extensive reforms in the banking sector, and the development of capital markets. These reforms allowed a better absorption of capital flows and the transition to a more efficient management of monetary policy, and made the banking sector more resilient to shocks and more apt to manage portfolio and currency risks in an environment of greater uncertainty.

In conclusion, Portugal had already foregone the flexibility of exchange rates before joining EMU, and relied on the stability of the exchange rate as a means for price stability. Even though the crawling peg regime was effective in restoring competitiveness in the presence of serious balance of payment crises, and the central parity of the escudo was subject to several realignments within the ERM, these devaluations occurred either in a framework of restricted capital movements or in a period of overall turbulence in exchange rate markets. Nevertheless, participation in a monetary union represents a much stronger (and irreversible) commitment compared to the previous regime. In a monetary union the improvement of competitiveness requires a real exchange rate depreciation, which can only be achieved by reducing costs and wages below that of competitor countries or by increasing productivity. Therefore, the existence of a monetary union puts some pressures on fiscal consolidation and on structural reforms, especially those aimed at strengthening wage and price flexibility as, with the loss of monetary poli cy, the burden of any required adjustment relies on them.

The impact that EMU may have on the effectiveness of other adjustment mechanisms is difficult to assess, as empirical evidence is still limited. There is some literature that argues that participation in a monetary union can contribute to make economies less vulnerable and more adaptable to asymmetric shocks – the claimed endogeneity of OCA criteria. This can be explained by the fact that a monetary union increases the need for reforms aimed at enhancing economic flexibility. However, it can also be argued that, in some aspects, this endogeneity may work in the opposite direction. For example, that the existence of a monetary union may constrain the capacity of a country to implement a comprehensive structural reform plan, or may reduce the incentives

Figure 12. *Inflation rate, 1985-2006*



Source: IMF.

to consolidate fiscal accounts, thereby impairing the capacity of an economy to adjust to shocks.

Duval and Elmeskov (2006) analyse the marginal impact of EMU on structural reforms in labour and product markets, and find some evidence that the loss of monetary independence may reduce a country's incentives to implement structural reforms. The main argument is the fact that although structural reforms contribute to expand potential output, they do not necessarily have a corresponding effect on aggregate demand. The fact that the capacity to boost demand is more limited and costly in a monetary union, given the inability to have a nominal exchange rate depreciation, reduces gains that could otherwise be obtained with these reforms. In addition, EMU eliminates the benefit of lower risk premium that could reasonably be expected with the implementation of structural reforms in a country with a single currency, as these reforms contribute to increase the resilience of the economy to shocks, and therefore reduce output volatility and the need for large swings in policy interest rates and exchange rates. This latter argument could also be made with respect to fiscal consolidation, as any gains in terms of reduced interest rates are absent, given that financial markets, so far, do not seem to differentiate significantly among euro area countries with respect to default risk. Furthermore, the Stability and Growth Pact constrains the use of fiscal policy to accommodate structural reforms, unless the country has a fiscal position close to balance or in surplus.

Considering how a monetary union has affected recent economic developments in Portugal, the prospect of EMU did initially imply an expansionary monetary policy stimulus. As nominal interest rates fell more rapidly than inflation, real interest rate were initially lower in Portugal than in core EU countries, implying a more expansionary monetary policy. As shown in Fagan, Gaspar (2007), the decrease in interest rates, experienced in some countries as a result of EMU, has been associated with a credit boom in household expenditures, leading to a deterioration of the current account balance. In the same vein, the economic slowdown reflects the adjustment of economic agents following a period of high growth fuelled by a credit boom (Constâncio 2005). However, the downturn in economic activity could have been minimised with the implementation of structural reforms to enhance the responsiveness of the supply side of the economy.

According to the above made argument, the positive demand shock associated with the regime shift should have eased the implementation of structural reforms. The prospect of EMU did not also prevent this monetary stimulus to be partly offset by the tightening of fiscal policy. At most, the pressures to concentrate on nominal convergence in order to comply with the Maastricht criteria might have contributed to deter policymakers from pursuing other objectives. Even though the prospect of EMU was accompanied by optimistic expectations concerning future income levels, which explains households and firms' expenditure behaviour, the fact that the loss of monetary autonomy required important reforms, seems not to have been consistently anticipated by policymakers.

Furthermore, the negative shocks due to weakened external demand and greater competition in trade would have affected the Portuguese economy whether in EMU or not. It is also not clear whether the exchange rate would have been the appropriate instrument to deal with the effect of these shocks. Evidence shows that in the presence of financial shocks, which can arise in an environment of liberalised capital movements, exchange rate movements tend to reflect changes in market sentiment, rather than fundamentals. In this respect, the Portuguese example shows that fixed exchange rates have worked well in anchoring inflationary expectations and providing financial stability in the past, even in the face of shocks caused by substantial amounts of capital inflows.

However, the existence of EMU may limit the policy responses, especially in face of negative demand shocks, and may increase the costs associated with the adjustment. The real exchange rate depreciation, needed to regain competitiveness and growth, requires a reduction in wages or an increase in productivity. As the effect of structural reforms on productivity is not immediate and nominal wages have usually lower downward flexibility, this may contribute to delay adjustment. Furthermore, the fact that the sustainability of current account deficits is less of a concern in a monetary union can also contribute to delay the implementation of needed reforms. The greater transparency and competition created by a single currency expose more clearly the impact of structural rigidities making these delays more costly. Furthermore, the role of fiscal policy as an adjustment tool is also more limited in a monetary union. Adherence to the limits set by the Stability and Growth Pact constrains a fiscal expansion. On the other hand, the possibility of a fiscal consolidation to have an expansionary effect, which relies on the impact of favourable expectations on lower interest rates, is also reduced in a monetary union, as nominal interest rates are set for the region as a whole.

3. Relevance of the Portuguese experience to New EU Members

New EU Member Countries share many characteristics with the Portuguese economy prior to euro adoption: lower incomes than the average of the euro area countries; rising real exchange rates (attributed to some extent to the real convergence process even though, in some cases, expansionary policies may also be a contributing factor); propensity to attract large capital inflows making

it difficult to manage monetary policy; low initial level of bank intermediation leading to rapid credit growth, which may easily result in economic overheating, a rise in asset prices and growing current account deficits.

When discussing EU enlargement issues, the statement that nominal and structural convergence should be pursued in parallel is frequently made. The two goals can be mutually reinforcing, at least in the longer term: greater nominal stability is essential to an improved business climate, higher investment and growth; and a more competitive and dynamic economy is more resilient to demand shocks with potential overheating effects. The Portuguese economy illustrates this statement both in a positive and negative way. The successful disinflationary process, in course at the time of the Portuguese accession to EC, was accompanied by comprehensive structural reforms, which improved the effectiveness of economic policies and the economy's resilience to shocks. This allowed a significant reduction of the output and inflation differential with respect to the EC average. By contrast, during the process leading to the adoption of the euro, focus was on the compliance with the Maastricht criteria. The fact that less attention was given to reforms aimed at enhancing economic efficiency at a time when expansionary policies were implemented, contributed to the appreciation of the real exchange rate, and led the basis for the future deterioration of competitiveness and large current account imbalances. It is important that these reforms are not delayed until entry. Some arguments made above are suggestive of the fact that participation in a monetary union may adversely affect the costs and incentives of implementing such reforms.

In terms of fiscal policy, given the limitations imposed by the Stability and Growth Pact, a balanced budget or in surplus would be an advantage, in order to allow automatic stabilisers to operate. Therefore, it might be prudent to go beyond the Maastricht criteria in order to avoid exceeding these limits, in case of a cyclical weakness.

In addition, signs of economic overheating should be monitored, as traditional measures of output gap may overstate potential output in transition economies. In particular, strong credit growth in some countries should be closely supervised as it may easily translate into excessive indebtedness and credit risk, especially if it reflects increasing risk taking by banks and a deterioration of credit quality, due to increased competition in the sector and lower profitability due to reduced interest rate margins. Although there is yet no indication that strong credit growth has undermined financial stability, it is important to watch development closely, as 'boom and bust' credit cycles are normally difficult to identify *ex ante*.

Careful consideration should also be given to the level of the exchange rate set for the central parity within the ERM2 and for the conversion rate of the euro, in order to prevent misalignments, which could lead to economic overheating (in case of an undervalued currency) or to large current account imbalances and subdued growth (in case of overvaluation). Equilibrium exchange rates are notoriously difficult to calculate in catching-up countries, as they are, to some extent, endogenous to the convergence process. Furthermore, given the propensity to financial market volatility and speculative capital flows, the role of market exchange rates as a useful reference can also be undermined. Given this uncertainty, it might be preferable to err toward the lower side as an overvalued exchange rate is more difficult to correct, since prices and wages are more likely to exhibit upward than downward flexibility.

4. Concluding remarks

The prospect of euro adoption provided an anchor for expectations, which allowed the decline of inflation and interest rates to historically low levels. The lower interest rates, together with the easing of liquidity constraints, contributed to the rapid increase in private sector credit. Optimistic expectations concerning the prospect of greater integration of income levels with the euro area further contributed to the expansion of consumption and investment and to the emergence of domestic and external imbalances. This demand-led growth, without sufficient efforts to enhance the response of the supply side of the economy, could not be sustainable over the long term once the economy reached full employment. To some extent, the downturn in economic activity reflects the adjustment of highly indebted economic agents following a period of strong economic growth caused by a credit boom. However, the economic slowdown was also caused by adverse external shocks, and could have been minimised with sufficient reforms to increase productivity and economic flexibility. Therefore, the most important message to new EU Member Countries, that can be derived from the Portuguese experience, is the fact that the loss of monetary and exchange rate autonomy requires enhancing the flexibility of other adjusting mechanisms in order to increase the economy's resilience to shocks. Even though the nature and extent of these shocks can be difficult to anticipate, this should not preclude the need to focus on structural convergence.

For a number of reasons, it is important that structural reforms should not be postponed. First, the initial positive performance of the economy can contribute to disguise the need for these reforms: traditional indicators of potential output or competitiveness may be misleading in transition countries; an increasing current account deficit can be justified by real convergence; and the adoption of a common currency implies that the sustainability of the current account is of a lesser concern. Secondly,

several arguments discussed above may indicate that the propensity to implement structural reforms may be more constrained after the adoption of the euro: a more limited capacity to boost demand reduces gains that could be achieved with the increase of potential output; adherence to the limits set by the Stability and Growth Pact limits the capacity of fiscal policy to accommodate structural reforms.

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