# European monetary integration and the Portuguese case
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The Portuguese case is a good illustration of both the benefits and the risks associated with monetary integration. To properly assess our case, however, we should consider the long period of membership since 1986. In this time span we can certainly be seen as a success story, which is also true if we start the analysis in 1992 — when we joined the Exchange Rate Mechanism (ERM).

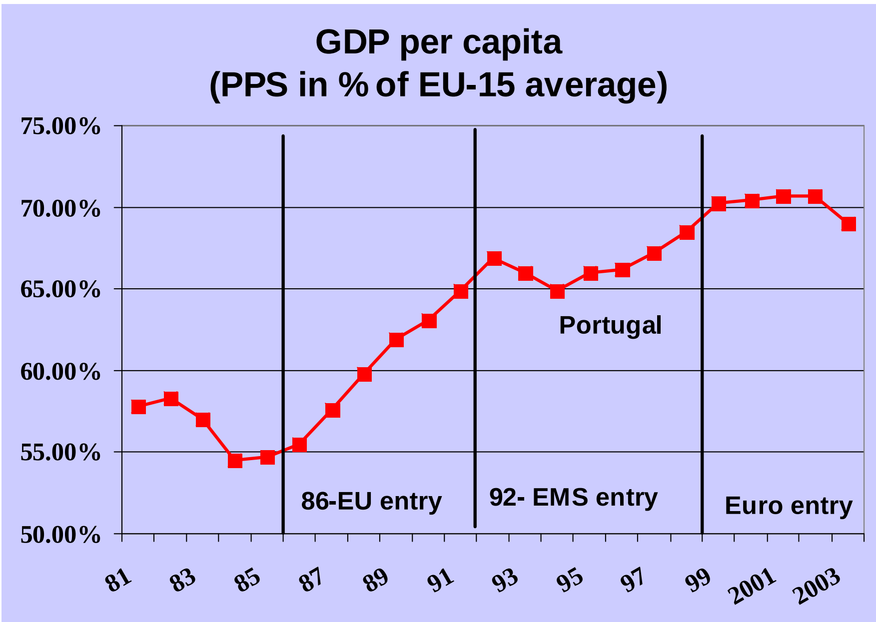


Figure 1

More recently, however, we have suffered a marked slowdown in growth and in 2001 we breached the 3% budget deficit limit imposed by the Treaty (Figure 2). The slowdown, which attained recession level with -1.3% growth last year, was very much influenced by the international economic slowdown, but stemmed also from the adjustment of economic agents after a period of high growth fuelled by a credit boom. I will maintain below that this type of see-saw development is the result of a practically unavoidable adjustment to a new intertemporal equilibrium associated with monetary unification.

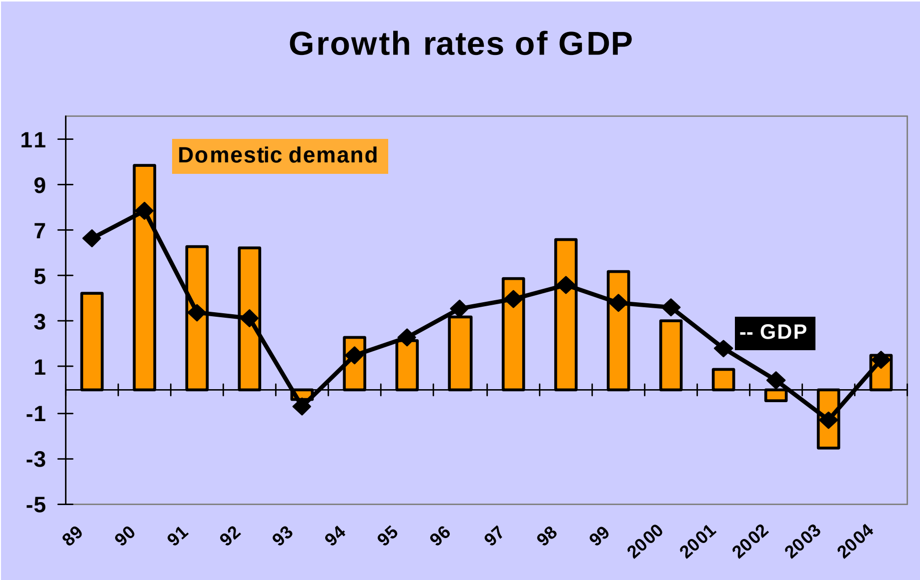


**Figure 2**

Nevertheless, the recent economic evolution also stemmed from some mistakes of our own. It can be said that the macroeconomics of a successful monetary integration is about economic agents adopting new rules regarding fiscal policy and wage behaviour. Fiscal policy needs to play a countercyclical role to act as a shock absorber. Wage behaviour should take as a reference wage cost developments in the euro area as a whole and should deviate from these only if there is a productivity growth differential. A different performance can lead to dangerous losses of competitiveness and can feed a divergent inflation process. In a Monetary Union, however, no country may for a long period have an inflation rate very much different from the average. Only inflation differentials that are justified by equilibrium movements of the real exchange rate are sustainable. In view of the recessionary nature of the adjustment, when price and cost inflation diverges, a sensible wage behaviour is essential to minimize future unemployment.

These new realities of life in a monetary union are only with difficulty taken on board by economic agents used to other regulation mechanisms for decades. As a consequence, our fiscal policy has been mostly pro-cyclical and our relative unit labour costs have increased more than the euro area average. We have aggravated, therefore, the risks of boom and bust behaviour. This is a considerable risk which, at an initial stage, confronts all countries coming from a relatively high inflation regime to join a low inflation monetary union.

There are several causes for the initial effect of acceleration of growth or even for real overheating. The first one stems from the decrease, and possible temporary misalignment, of interest rates and the credit boom that follows from that. The second reason is associated with large capital inflows that add to demand pressures and may be caused either by Foreign Direct Investment or short-term capital movements related with interest rates convergence plays. Finally, the third group of causes is related with more direct pressures on prices coming from several possible factors: a strong Balassa-Samuelson effect; a catch-up movement in price levels: liberalization of administrative prices; harmonization of VAT; adoption of Common Agriculture Policy prices, etc....

All the factors just mentioned create pressures that may lead to several problems:

a) Boom and bust cycles followed by a possible recession;
b) Overheating in asset markets (housing and stock exchanges);
c) Competitiveness problems with consequences for the current account, especially if unit labour costs become misaligned. [1]
d) Financial stability risks if credit institutions are allowed to incur excessive risks in the context of an overheated economy.

As I have mentioned already, these problems may occur before joining the euro within ERM or after the adoption of the euro in spite of the regime change. This implies, among other things, that for candidate countries to optimize the speed of convergence, they should make proper use of ERM II; control the risks associated with overheating; and continue to implement reforms to improve their growth potential and increase total factor productivity without being misled by the initial good performance of the economy.

## II. ERM participation

The Portuguese experience has some lessons of interest both for the case of ERM participation and of euro adoption. I will first address ERM participation. ERM is both a test of the capacity of countries to participate in a monetary union and a useful mechanism to steer economies to comply with the Maastricht criteria. I can understand the reluctance of some new Member States in accepting the need to go through ERM participation before

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[1] Before countries join the euro the pressure will be exerted on nominal exchange rates. We should nevertheless be aware that even after joining the euro, a country continues to have a real exchange rate, given by inflation differentials, and excessive appreciation may emerge or be made more serious.

joining the euro. There are of course two different cases. Small countries with fixed exchange rate regimes can understandably envisage staying in the Exchange Rate Mechanism for as short a period of time as possible. For countries with flexible exchange rate regimes, including those shadowing ERM, participation in the ERM can be useful as the ±15% band allows exchange rate flexibility to help stabilization and absorb inflationary pressures. At the same time, ERM acts as a disciplinary framework as adequate domestic policies are essential to ensure compliance with the commitment to exchange rate stability. But the ERM is also a flexible framework as realignments are possible and should be used if necessary. This means that the initial central rate should not be seen as the future conversion rate. Also, with the wide bands, the ERM - although giving priority to exchange rate stability - still allows room for an independent monetary policy to target inflation, in what is a workable hybrid system.

Our experience illustrates many of the points I have just mentioned about the Exchange Rate Mechanism. Portugal initiated an exchange-ratebased stabilization program in 1990 and entered the ERM in April of 1992. Inflation reduction was consistently achieved throughout the decade (Figure 3).

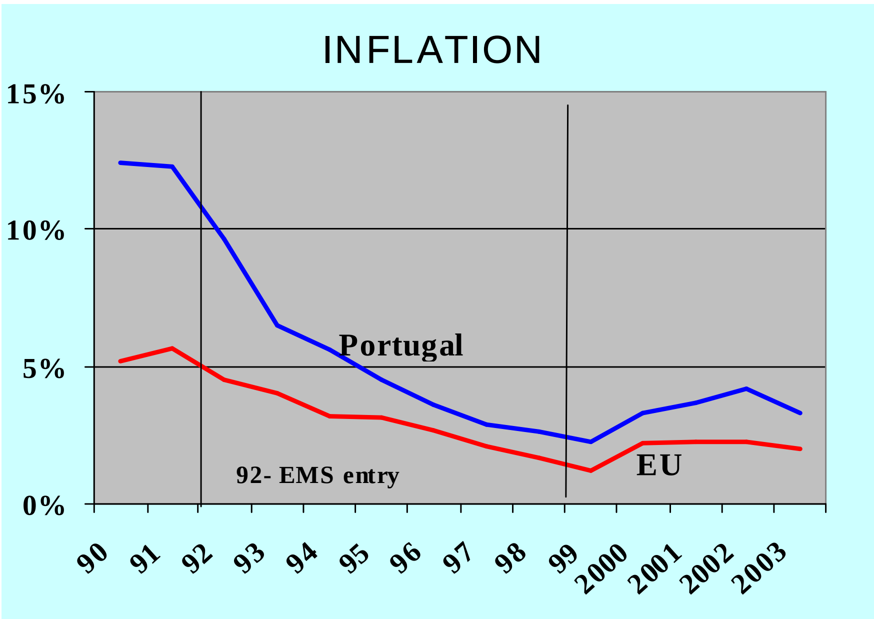


Figure 3

The disinflation process, based on nominal exchange rate stability, was of course accompanied by real exchange rate appreciation (Figure 4) although until 1999 there was no significant Current Account deficit.

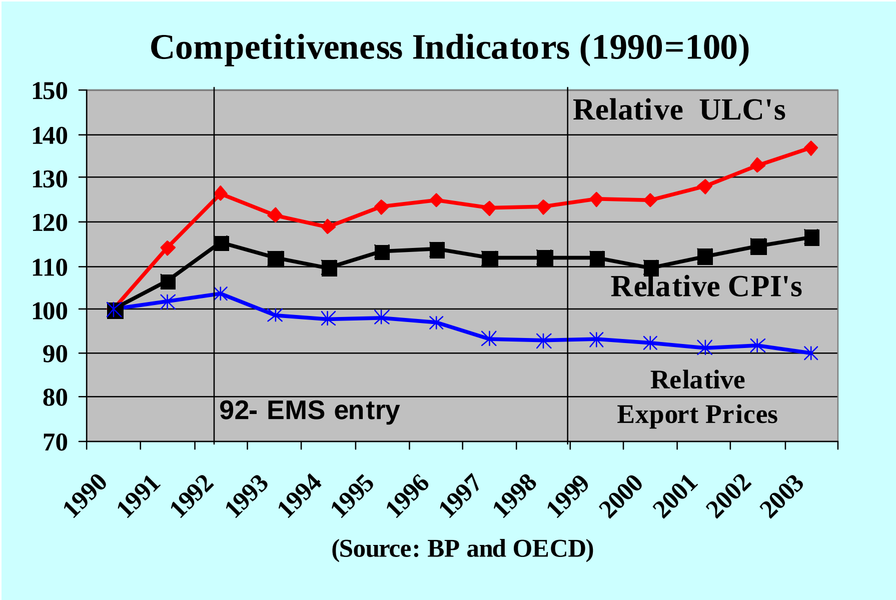


Figure 4

The following graph [2] (Figure 5) illustrates the exchange rate developments and some of the policies used to defend the parity during the period of our participation in the ERM. In the top part of the graph we have the escudo/ deutsche Mark exchange rate with the respective central rate and permitted fluctuation bands. In the lower part, referred to the left-hand scale, we have in green the overnight interest rate and in brown an intervention index (the amount of daily intervention divided by the highest amount in the period 1992-1998)

[2] Extracted from Bernardino Adão and Joaquim Pina (2003) “A experiência do escudo no MTC e a eficácia da gestão cambial” *Boletim Económico* do Banco de Portugal, Junho 2003

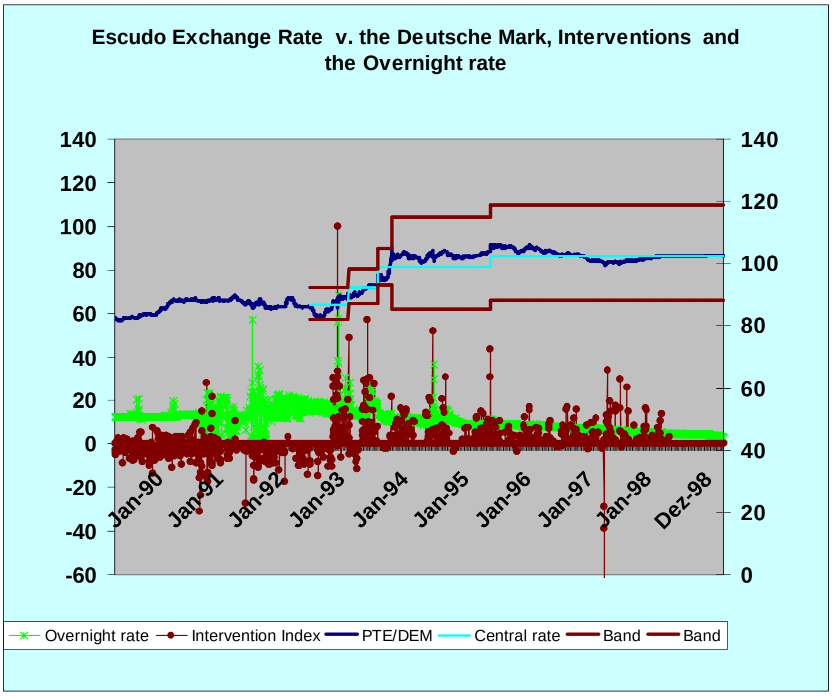


Figure 5

Initially, in 1990-1992, there were capital inflows and a tendency for nominal appreciation. All capital inflows were sterilized, and this was naturally very expensive. Sterilization increased interest rates, which were already very high to fight inflation. This led to more capital inflows (4% of GDP in 1990, 8% in 1991 and 7% in 1992). We suffered from the well known contradiction between a tight monetary policy to fight inflation and the objective of exchange rate stability. This happened in spite of some existing capital controls that were only totally dismantled in Dec 1992.

Entry into the ERM was helpful notwithstanding the initial turmoil in the system. We were victims of contagion and the escudo was under attack after September 1992, when Portugal did not follow a realignment of central rates by other countries. This led to a significant speculative episode that was nevertheless successfully resisted. The policy response consisted in a determined and simultaneous use of interventions in forex markets and interest rate moves. Active episodes of intervention (interventions or interest rate moves above 2.5 standard deviations of the period) were 4.4 % of total days of the period and were successful 91% of the time. Successful in the sense that after an intervention the exchange rate appreciated (Frankel criterion [3]) or depreciated less than before (Humpage criterion [4]).

During the period of turmoil in the system we changed the escudo's central parity three times (Nov 1992, -6%, March 1993, -6.5%, May 1995, -3.5%) without ever having reached the band limits. These realignments helped to offset the initial high appreciation of the currency. Also, they did not harm the disinflation process, which continued to be based on a tight monetary policy and a nominal exchange rate that did not completely offset inflation differentials. As it is stressed in an IMF working paper [5] on exchange-rate-based stabilizations in Greece, Ireland, Italy and Portugal, there was no relation in all these countries between fiscal policy and disinflation. Credibility of the disinflation process was more related with a general sustainability assessment than with the speed of deficit reduction. All these points prove the flexibility of the Exchange Rate Mechanism and the advantage in not seeing the initial central rate as the future conversion rate.

We stayed in the ERM for six years with exchange rate stability after 1993, as domestic policies gradually gave credibility to the objective of participating in the Monetary Union. The disinflation proceeded smoothly, without excessive demand pressures or inflation surges. This development has been influenced by very high interest rates in the first few years and by the European recession of the early 90's that also led to a recession in Portugal in 1993. So, during this period, we did not suffered the Exchange Rate Based Stabilization syndrome of high growth, high capital inflows, high real appreciation, and high Current Account deficits, common features in other experiences. That came later as euro adoption approached and during the first two years of monetary union membership.

In different experiences where inflationary pressures become intense, a contradiction may appear between the Maastricht criteria of exchange rate stability [6] and of inflation performance. This may explain why some countries would like to stay only a very short period in the ERM. That is more understandable for countries with hard pegs as pressures

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[3] Frankel, J.(1994) Commentary to Catte, Galli and Rebecchini "Concerted Interventions and the Dollar: An Analysis of Daily Data", in "*The International Monetary System in Crisis and Reform: Essays in Memory of Rinaldo Ossola*", edited by P. Kenen, F. Papadia e F.Saccomani, Cambridge University Press.

[4] Humpage, O.(1996) "U.S. Intervention: Assessing the Probability of Success", Federal Reserve Bank of Cleveland *Working Paper* No. 9608.

[5] Enrica Detragiac and Alfonso Harmann (1997) «Exchange rate based stabilization in Europe: Greece,Ireland, Italy and Portugal» IMF *Working Paper* 97/75

[6] I am referring to the requirement of staying two years before joining the euro without realignments or severe tensions affecting the exchange rate.

for higher inflation could not be offset by allowing the currency to appreciate within the band. For countries with flexible exchange rate regimes, the possibility of allowing exchange rate moves within the wide bands may be useful, provided they will not stay long without achieving, with credibility, a situation approaching compliance with the Maastricht criteria. That is why they should carefully consider the timing of joining the ERM. It would be preferable if they were to join when already well advanced on the path to compliance with the criteria. In practice, of course, the concrete situation of each country has to be properly assessed.

To conclude this point, I would stress that the first condition for successful preparation of the way for entry into the euro area is the correct use of participation in the ERM as a disciplinary framework and as a flexible way to manage the pressures associated with the convergence process.

## III. Monetary Union: risks and policy response

### 1. Risks of overheating: an unavoidable adjustment to a new intertemporal equilibrium?

The tendencies for higher inflation and possible overheating will continue to exist in a Monetary Union and can even become stronger and unavoidable. There is a sort of EMU shock as countries undergo a true change of economic regime. The main features of this change of regime with the adoption of the euro are the following:

a) Increased substitutability of financial assets;
b) Consolidated reduction in the cost of capital;
c) Increase in wealth and reduced liquidity constraints;
d) Different meaning of the current account and primacy of credit risk.

All these aspects are a direct result of monetary and financial integration that equalizes monetary rates, reduces risk premium as national currencies disappear and promotes integration of capital markets. This facilitates debt financing and equity issuance with an overall reduction in the cost of capital. Member countries no longer suffer from what Eichengreen and Hausman [7] called «original sin», i.e. the difficulty of long term domestic financing at fixed rates or of issuing external debt in their own currency. As a result, the current account deficit is financed in their own currency and ceases to be a macro-monetary problem to become just the result of the budget constraints of all resident economic agents. What matters now is dominantly the credit risk, and this gives a totally different meaning to current account problems.

For countries coming from an economic regime of higher inflation all these features create the conditions for demand/credit booms and possible overheating that may emerge through the following two channels:

a) The drop in interest rates increases wealth, reduces liquidity constraints and favours consumption intertemporal smoothing, which decreases savings in the present period. (Blanchard and Giavazzi [8])

b) The reduction of the cost of capital and the prospects of higher growth as a result of goods markets integration (the so-called Rose effect [9]), lead to investment growth.

The two types of mechanisms just mentioned are, of course, two of the more important channels of transmission of the positive effects of euro membership. Nevertheless, they create risk, thus confirming that there can always be too much of a good thing.

The most important instruments to deal with these problems are the anti-cyclical use of fiscal policy; sensible wage policy; and good prudential supervision of the financial sector.

The Portuguese case is a good one to illustrate some of the developments just mentioned. In fact, the drop in interest rates was significant after 1995 and by then membership of Monetary Union seemed more assured. As a consequence, we had a credit explosion (Figure 6).

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[7] Barry Eichengreen and Ricardo Hausmann (1999) “Exchange Rates and Financial Fragility “ in “*New Challenges for Monetary Policy*” A symposium sponsored by the Federal Reserve Bank of Kansas City

[8] Olivier Blanchard and Francesco Giavazzi (2002) “Current Account Deficits in the Euro Area. The End of the Feldstein Horioka Puzzle?”, mimeo

[9] Andrew K. Rose (1999) “One Money, One Market: Estimating the effect of common currencies on trade” NBER *Working Paper* 7432

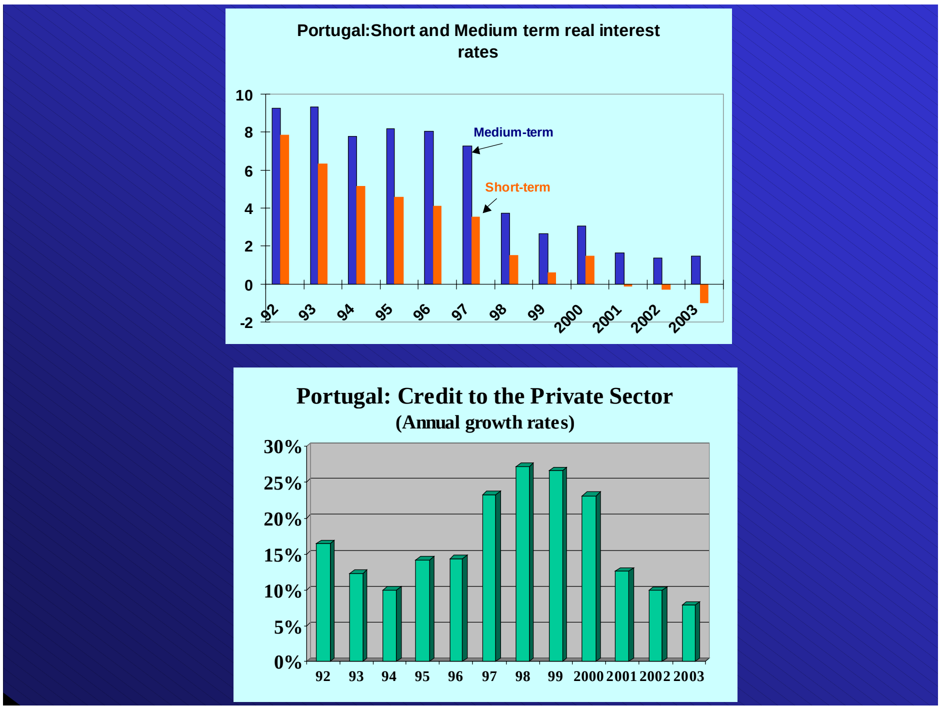


Figure 6

This is mostly a process of adjustment to a new steady state as rational agents implement intertemporal consumption smoothing and investment jumps to take advantage of higher growth prospects and the lower cost of capital. The surge in both consumption and investment was financed by the banking system, which was able to get funding abroad in euros and so could increase credit much more than deposits as the savings rate continued to decline.

There was, of course, an explosion of debt in both households and companies, which was possible because total interest rate charges increased only marginally for households and actually decreased for firms throughout the decade (Figure 7). Total financial charges (interest and principal) for families stand now at 14% of disposable Income, as indebtness was overwhelmingly related to housing in the form of long-term credits with low annual amortization.

Household debt, interest charges and total financial charges in % of Disposable Income

Debt of Firms and interest charges (% of GDP)

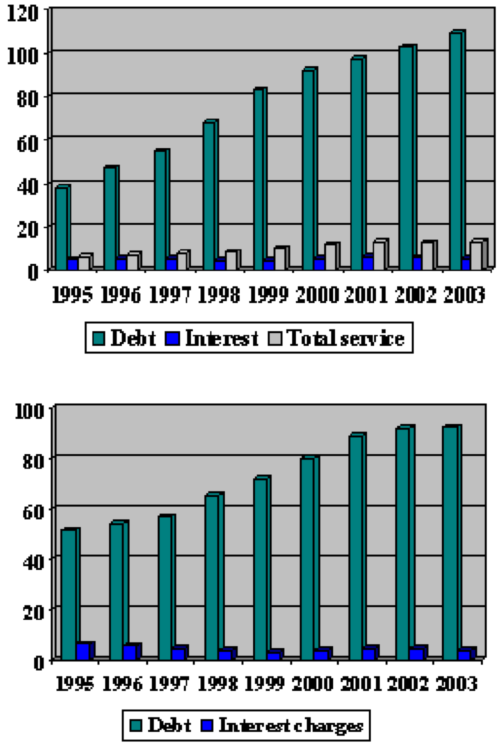


Figure 7

The increase in indebtness was associated with an increase in the investment rate and a decline in the savings rate, in the latter case continuing a movement under way since disinflation began (Figure 8). The counterpart of these developments was an increase in the external deficit (current account plus capital account).

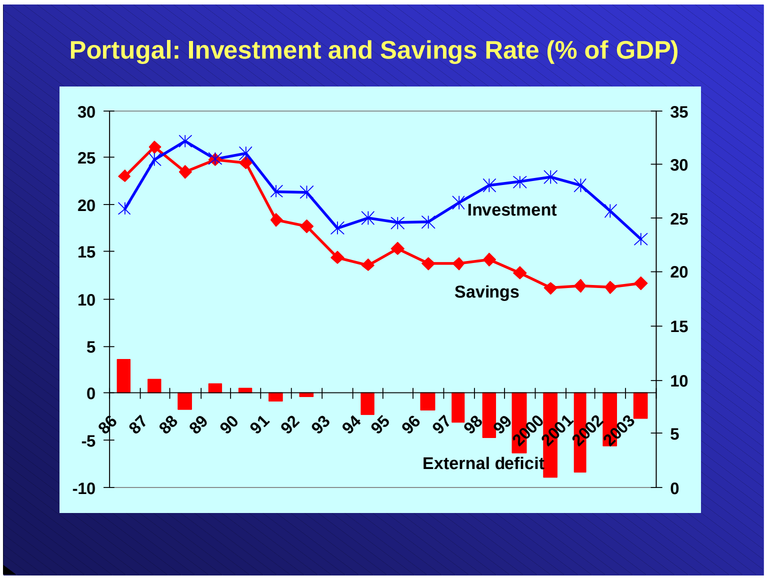


Figure 8

However, as I mentioned before, the current account of a member of a monetary union has a totally different meaning from the case of a country that has its own currency. In a monetary union, the financing of a member country current account is carried out in the common currency with reduced liquidity constraints. The balance of payments is no longer an autonomous macro monetary restriction, it is the result of the borrowing requirements of domestic agents conditioned by their own budget constraints. Rational agents' behaviour will reflect these constraints and microeconomic credit risk analysis as it is performed by the financial sector is now the important mechanism of control. The consequence of all these factors is a gradual decline in the Horioka/Feldstein effect within the euro area as Blanchard and Giavazzi (2002) [10] have pointed out. In fact, investment can become less correlated with domestic savings as a result of in-depth monetary and financial integration.

After 2000, the external deficit started to decrease and it is important to underline that this evolution resulted from the spontaneous change of behaviour of indebted private agents, proving that the two mentioned self-correcting mechanisms were playing their role.

The private sector as a whole had in 1995 a positive financial balance of 5.7% of GDP but this changed to a deficit of 5.8% in 2000, whereas the public sector reduced its excess of investment over savings (Figure 9) . Since 2000 private agents have started to reduce investment and increase savings, reaching a balanced position last year. What happened was clearly a market-driven adjustment by the private sector. The initial surge of expenditure was as unavoidable as the correction was spontaneous and equally rational. [11]

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[10] Olivier Blanchard and Francesco Giavazzi (2002) "Current Account Deficits in the Euro Area. The End of the Feldstein Horioka Puzzle?", mimeo

[11] Nevertheless, I should mention that in the first half of this year we had an unexpected surge in imports, implying an elasticity to domestic demand that is historically an outlier but will unavoidably affect this year's current account.

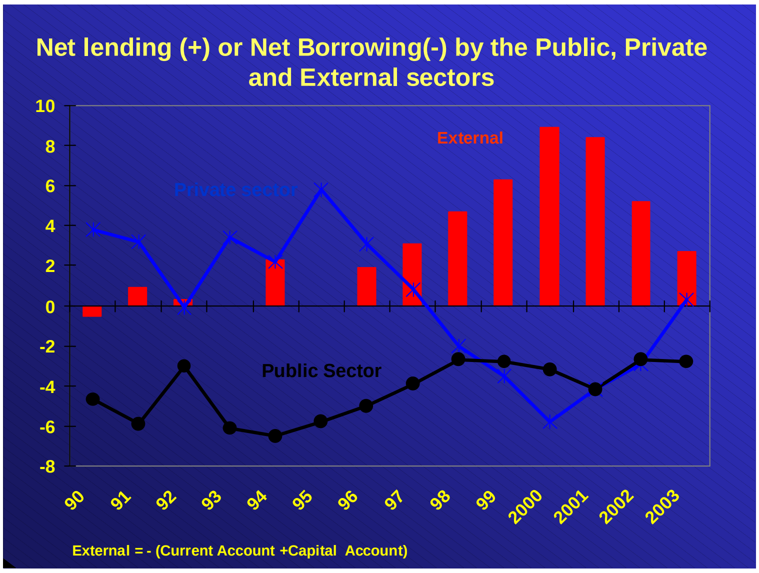


Figure 9

The problem is not the current account imbalance as such if it is the result of one-time rational adjustment to a new intertemporal equilibrium. Imbalances that stem from a rational adjustment by private agents have market-driven self-correcting mechanisms that operate through change of competitiveness and the effect of budget constraints monitored by the financial sector.

Regarding the more recent developments of the Portuguese economy, it should be stressed that the drop in domestic demand associated with the self-correcting adjustment of the private sector contributed to the recession we had last year (Figure 10). Another important factor was the big decrease of external demand directed to the Portuguese economy. This fell from an average of 9% (1995-2000) to 1.4% in 2001 and 0.8% in 2002. Fiscal policy didn't help either as after breaching the 3% limit in 2001 we had subsequently to adopt a pro-cyclical stance. This leads me to the next point about the role of fiscal policy.

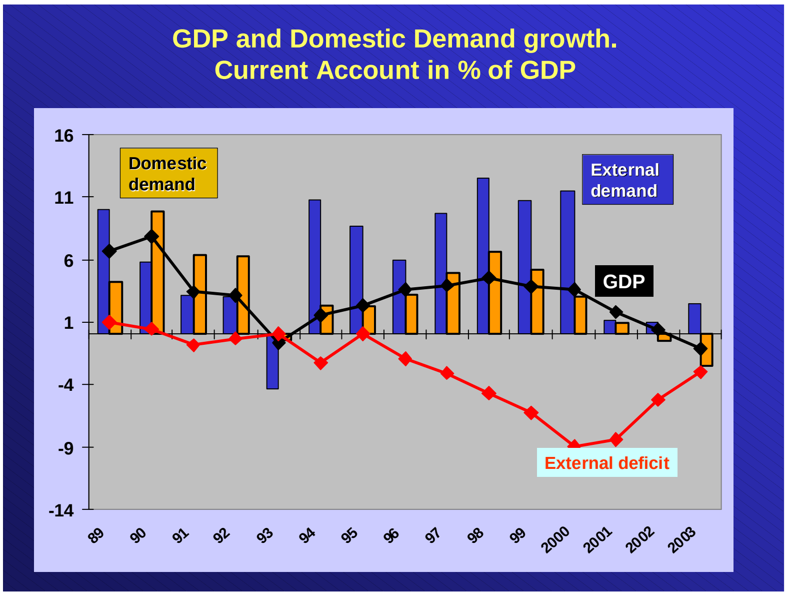


Figure 10

## 2. The role of fiscal policy and self-correcting mechanisms

Portugal misused fiscal policy twice in the decade. The first time at the moment of entering the ERM, which may have contributed to some contagion effects at the time of ERM turmoil in 1992. The second time after 1996, when the savings from the decrease in public debt interest charges were used to increase current expenditures. In fact, twice in the decade we had significant increases in current primary expenditures, basically the wage bill (Figure 11).

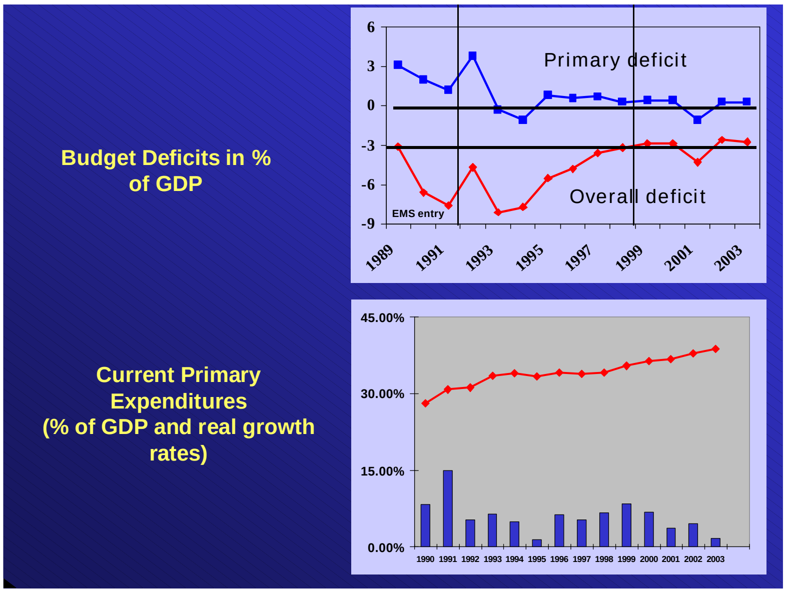


Figure 11

The reduction in interest payments generated an unjustified optimism about what the State could spend. The consequence was a pro-cyclical fiscal policy, which, when the economic deceleration came in 2001, led suddenly to a deficit above 4%. To correct this excess, policy had to continue to be pro-cyclical, this time in the restrictive direction. Figure 12 illustrates this by combining the evolution of interest rates and the State's primary deficit (cyclical adjusted and without one-off revenue measures) to show periods of a restrictive change in macroeconomic conditions when the line moves to the right and up and periods of expansionary change in policies when it moves to the left and down.

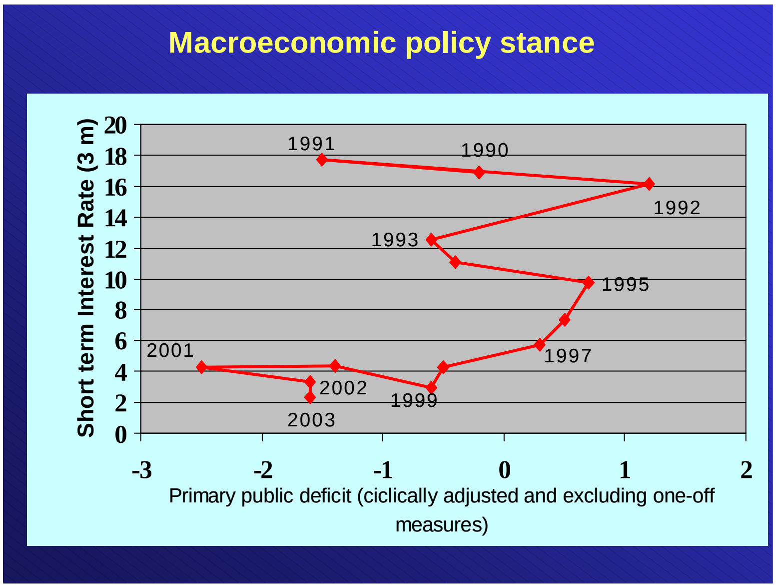


Figure 12

The lesson to draw from this is that a country within the euro area must always keep a margin of safety in fiscal policy to be able to face an economic slowdown without the risk of breaching the 3% limit.

Another point worth mentioning refers to the limits of fiscal policy in the context of the initial stages of monetary union participation. As our case illustrates, the budget stance did not create a demand boom and it would be asking too much of fiscal policy to think that it could have been able to significantly offset the explosion of private expenditure. Fiscal policy should Undoubtedly, have been countercyclical in terms that would have allowed us to avoid breaching the Stability Pact. Nevertheless, it is also important to note that a reasonable policy could not have smoothed the cycle very significantly. The reason is that the budget multipliers of very open economies like ours are in general fairly small.

**Fiscal Revenue and Expenditure Multipliers**

| | QUEST | |
|---|---|---|
| | **Revenue** | **Expenditure** |
| **Austria** | **0.1** | **0.5** |
| **Belgium** | **0.1** | **0.5** |
| **Finland** | **0.3** | **0.4** |
| **France** | **0.1** | **0.5** |
| **Germany** | **0.2** | **0.4** |
| **Greece** | **0.1** | **0.5** |
| **Ireland** | **0.1** | **0.4** |
| **Spain** | **0.0** | **0.7** |
| **Portugal** | **0.1** | **0.5** |

**Source: P. Hoeller et al (2002) "Overheating in small euro area economies: should fiscal policy react ?" OCDE WP nº 323, Feb 2002**

Figure 13

As stated in an OECD working paper [12] on this subject: "With low fiscal multipliers, big swings in expenditure or revenues would be needed to damp the cycle. Such volatility would undermine the effectiveness of fiscal policy and the credibility of a rules-based fiscal policy."

Simulations using the Banco de Portugal model show that to bring the 2001 budget deficit 2 percentage points lower, through a policy of slowing down primary expenditures

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[12] P. Hoeller *et al* (2002) "Overheating in small euro area economies: should fiscal policy react ?" OCDE WP nº 323

since 1998, the cost in terms of GDP growth would have been 3.5% in accumulated terms, i.e. around 20% of the growth achieved in that period. In such a scenario, the current account deficit would have been reduced only from 8 to 6% of GDP.

To conclude this point about the role of fiscal policy, it should be underlined that fiscal policy, in spite of its limitations, is essential to counter the more negative effects of a demand/credit boom and partially smooth the cycle. In particular, the Portuguese experience shows the importance of some other points. Countries should maintain at all times an anti-cyclical fiscal policy. A prudent approach requires that real budget consolidation with a deficit well below 3% should be achieved before adopting the euro. On the other hand, the structural deficit should never exceed the level compatible with the full play of the automatic stabilizers without breaching the 3% limit. Finally, countries should introduce structural reforms early on to contain future budget pressures, and should adopt efficient institutional procedures for the preparation and implementation of the budget. These should include, for instance, multi-year expenditure commitments approved by Parliament. Also, in view of the need to invest in infrastructure and the limitations of the Stability Pact, which does not allow the use of debt over the cycle to finance those expenditures, adequate rules for Public Private Partnerships (PPP) and project finance should be introduced to ensure real transfer of risk, transparent accounting of multi-year commitments and limits to future expenditures.

All the preceding points justify some general conclusions about the appropriate policy responses for countries acceding to the European Union and the euro. The list is very simple and contains very well known points:

a) Adequate use of the ERM should be ensured with flexibility but also with a sense of the primacy of the exchange rate commitment. This implies that monetary policy cannot be conducted according to a regime of pure inflation targeting and this fact must be clear to the markets. Also, the initial central rate should not be seen as being necessarily the future conversion rate into the euro.

b) A permanent anti cyclical fiscal policy has to be applied to be able to absorb shocks coming from fluctuations of external demand or capital inflows. In this perspective, a very solid and cautious budget position should be built before joining the euro.

c) A realistic wage behaviour has to be ensured to avoid excessive real appreciation in terms of relative unit labour costs.

d) An efficient prudential supervision of the financial sector must be guaranteed, taking financial stability risks seriously.

We can look at these principles just as a particular case of the general recommendations that come from modern growth theory. Besides the aspects related with macroeconomic stability, openness of the economy and non-distorted markets, the modern approach underlines the importance of institutions and good governance. Countries should make sure that they are continuously making progress in this respect. In our case we have made great strides in the past couple of decades. However, having attained a good intermediate position we now face the difficult task of making further progress. In the present world conditions, no country can rest on past achievements. A permanent and determined policy of structural reforms is essential to increase or even just to maintain the rate of potential growth. Combined with the need to achieve a real fiscal consolidation, the effort to increase our growth potential constitutes the main challenge that Portugal now faces. A challenge that we are certainly better positioned to overcome within the demanding framework of the European Monetary Union.