Portuguese Republic

Ministry of Finance and Public Administration

Euro@10

Lessons from the Portuguese experience

Fernando Teixeira dos Santos

Minister of State and Finance

Universidade do Minho
May 2009

Summary

- **The Euro and the European integration**
- **The Euro and the financial markets**
- **The Euro and macroeconomic stability**
- **The Euro and the public finances**
- **The Euro and the current economic crisis**

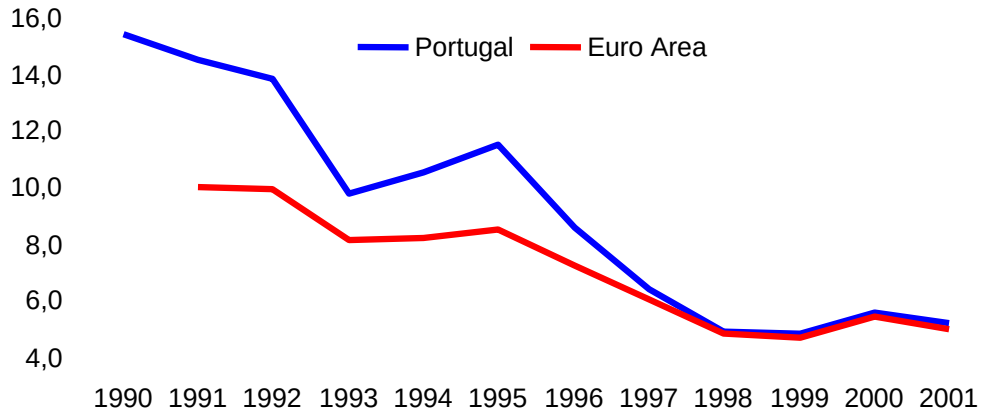
The Euro and the European integration

- **The Euro is a political and economic project whose success became an important pillar of the process of European integration**
- **The political success of the Euro must be highlighted and not just emphasize the positive economic impacts derived from the Economic and Monetary Union (EMU)**
- **The Euro became a true instrument of the European citizenship by giving people the freedom to move to different countries without currency restrictions**

The Euro and the financial markets

The Euro promoted financial convergence and reduced financial costs, as markets became more transparent and transaction costs diminished

- **Convergence of short-term and long-term interest rates to relatively low levels**



Nominal Long-Term Interest Rates

Source: Ameco

- **Increase of cross-border financing (Spiegel, 2004): Portugal increased its borrowing from euro-area countries (from 37.5% of overall borrowing in 1986-1991 to 85.6% in 1999-2003)**

- **Absence of currency crisis in euro area (v.g. the ERM crises of 1992-3) and positive spillovers to other countries (SW, DK) that pegged their currency to the euro**

The Euro and macroeconomic stability

Economic Policy: Managing Economic Cycles in EMU

- **Centralized Monetary Policy: conducted by a single entity that is responsible for assuring price stability**

National governments no longer have the interest rate and exchange rate instruments to boost competitiveness and thus to promote cyclical adjustments, which is particularly significant for small open economies, as the case of Portugal

- **Decentralized Fiscal Policy: automatic stabilizers and discretionary measures**

Yet, member states must comply with budgetary rules set up in the Stability and Growth Pact, which impose restrictions on the use of fiscal policy as an instrument to promote cyclical adjustments

⬇

Fiscal Discipline

The Euro and macroeconomic stability

Economic Policy: Managing Economic Cycles in EMU

- **Real Adjustment (microeconomic reforms) and macro sound management emerge as the key economic policy instruments available to national governments**

⬇

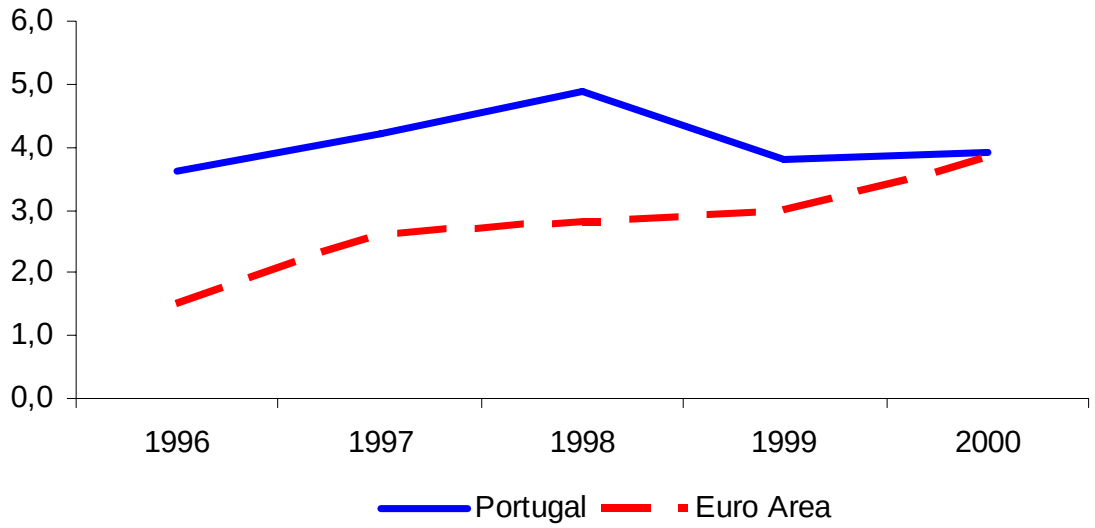
Lisbon Agenda

- **Focus on economic growth and employment**
- **Concern for sustainability**
- **Structural reforms (goods and services, financial and labour markets)**

The Euro and macroeconomic stability

The Portuguese Experience

In the second half of the 1990s, the run up to the EMU and the adoption of the euro provided the Portuguese economy with a significant boost in domestic demand largely associated to the increase in wealth due to the global economic good times, the sharp decline in interest rates and the elimination of liquidity constraints.



GDP Growth
(% change on previous period, constant prices)

Source: Eurostat.

The Euro and macroeconomic stability

GDP growth was based on Domestic demand (both consumption and investment) …

	1996	1997	1998	1999	2000
GDP (% change on previous period)	3,6	4,2	4,8	3,9	3,9
Components of Growth					
Domestic Demand	3,7	5,8	7,4	6,4	3,6
External Balance (Goods and Services)	-0,2	-1,6	-2,6	-2,5	0,3

Source: Eurostat.

… boosted by wealth effects arising from lower interest rates and credit availability and consequently decrease in savings rate.

Productivity gap with the EU narrowed, as a result of strong investments in transport and telecommunications infrastructure…

Labor Productivity per Hour Worked

1996	1997	1998	1999	2000
60,8	62,5	63,5	64,7	66,1

GDP in Purchasing Power Standards per hour worked relative to EU-15 (EU-15 = 100)

Source: Eurostat.

The Euro and macroeconomic stability

Portugal complied with the (nominal) convergence criteria and became a cofounder of the Euro Zone.

However…

Reduced increase in potential supply:

- **Growth in demand was not followed by a parallel increase in potential supply, mainly due to insufficient microeconomic reforms preventing productivity growth from supporting catching-up dynamics.**
- **Wealth effects associated with economic good times have delayed the urgency of structural reforms**
- **Political circumstances (lack of strong political support, as the government was supported by a minority in the parliament) led the government to concentrate the efforts on the necessary measures to comply with the Maastricht criteria (e.g. fiscal consolidation) instead of dispersing political will over too many simultaneous reforms**

⬇

Joining the euro was a political priority so to achieve fiscal discipline

The Euro and macroeconomic stability

However…

Severe negative shocks in external demand…

- **Intensification of international competition (e.g. Asia - liberalization of global textile and footwear trade).**
- **European Union enlargement, opening European markets to East European emerging economies. These emerging economies also deviated Foreign Direct Investments away from Portugal.**
- **Portuguese competitiveness still relying on traditional products and low levels of human capital.**

… aggravated by high rates of growth in unit labor costs fuelled by overoptimistic expectations and by a tight labor market induced by the dynamics of non-tradables' less competitive markets

The Euro and macroeconomic stability

Portuguese economy slowdown

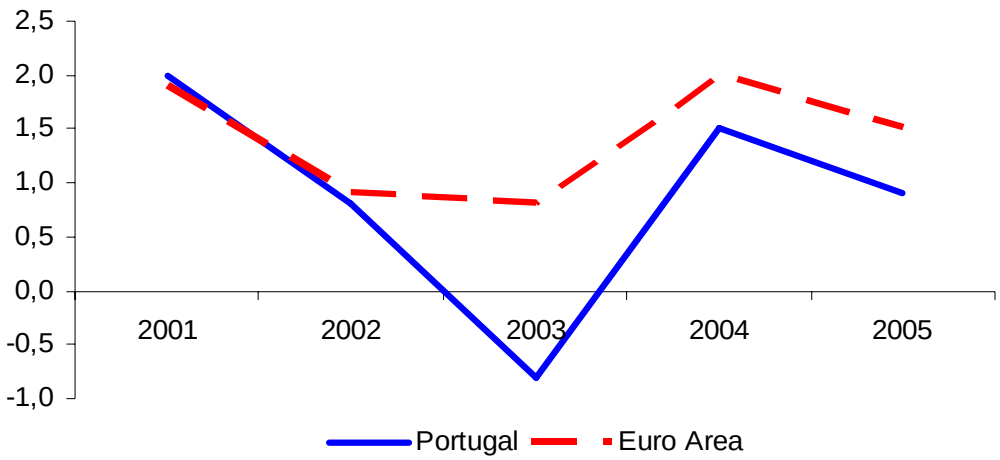
	2001	2002	2003	2004	2005
GDP (% change on previous period)	2,0	0,8	-0,8	1,5	0,9
Components of Growth					
Domestic Demand	1,8	0,1	-2,2	2,7	1,6
External Balance (goods and service)	0,2	0,7	1,4	-1,2	-0,7
Unemployment (%)	4,0	5,0	6,3	6,7	7,6

Source: Eurostat.

Portuguese convergence process reversed

GDP Growth
(% change on previous period, constant prices)

Source: Eurostat.



The Euro and macroeconomic stability

- **Was the euro responsible for economic slowdown and the severe economic adjustment?**

  No. Simply, the euro and the loss of the interest rate and exchange rate instruments, traditionally used as placebos, made more apparent the need for a real adjustment

- **In Spring 2005, the renewed Lisbon Strategy was assumed a priority of the new Government and represented a turn-around in the pace of reforms' implementation (at the macroeconomic and microeconomic level)**

- **Main Reforms:**
  - **Public Finances**
  - **Modernization of Public Administration**
  - **Human Capital (qualifications, employability and education)**
  - **Labour market reforms**
  - **Science and Technology**
  - **Social Security**
  - **Healthcare**

The Euro and macroeconomic stability

Lisbon Strategy and Quality of Public Finances must be at the hearth of Economic Policy Governance in the Euro Area

Quality of Public Finances
- Efficiency and effectiveness of Public Policies

Macroeconomic stability
-Single monetary policy
- Stability and Growth Pact

Lisbon Strategy
- Economic growth and employment
- Microeconomic policies and structural reforms

The Euro and the current economic crisis

The recent economic crisis showed that:

- **The ECB, a key institution in the euro framework, assumed a world leadership role in fighting the financial turmoil, namely through guaranteeing adequate liquidity to financial institutions**
- **Although the much positive coordination effort, the fact is that the EU budgetary framework lacks adequate instruments to promote a significant and centralized anti-cyclical fiscal policy**
- **The benefits of the EMU are driving some non-EMU countries to step up their efforts to comply with the criteria to join the euro area**

Conclusions

Lessons learned from the Portuguese Experience:

1. Expectations on future income should be looked with caution, especially in economic "good times";

2. Ideally, reforms should be implemented before entering the euro, so that the economy becomes more flexible and prone to real adjustment without higher costs such as increasing unemployment

- Coordination between structural reforms and stabilization policies (fiscal and monetary) is easier to do before UEM

- The increasing competitiveness made possible by structural reforms permits reaping more benefits from EMU and from open markets and increasing competition derived from globalization

Conclusions

Lessons learned from the Portuguese Experience:

3. Political support and discipline are needed to undertake reforms.

- **In Portugal, political support allowed the country to meet the (nominal) Maastricht criteria, but was not enough to support structural reforms**

Delay of reforms → **Painful Real Adjustment**

- **But it is never too late, although the results of reforms could have been achieved sooner.**

- **The Lisbon Strategy has been proving a very useful framework for the design of structural reforms.**