

# Ministry of Finance and Public Administration

**EMU@10**

**What can we learn from the Portuguese experience?**

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## Summary

- **1 Jan 1999: Economic and Monetary Unit**
- **Portugal: The run up to Euro-Area Membership**

A period of increasing wealth due to global economic good times, to a sharp decline in interest rates and to the elimination of liquidity constraints, although with the appearance of some macroeconomic imbalances.
- **Portugal: The Turn of the Century**

A period of slowdown in the Portuguese economy associated to severe negative shocks in external demand and to the process of real adjustment to correct macroeconomic imbalances.
- **The Portuguese National Reforms Programme**
- **Signs of Recovery – Recent Economic Developments**
- **Summary and Overall Lessons**

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# 1 Jan 1999: Economic and Monetary Union

## 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 SGP, which impose restrictions on the use of fiscal policy as an instrument to promote cyclical adjustments



**Fiscal Discipline**

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## 1 Jan 1999: Economic and Monetary Union

### 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



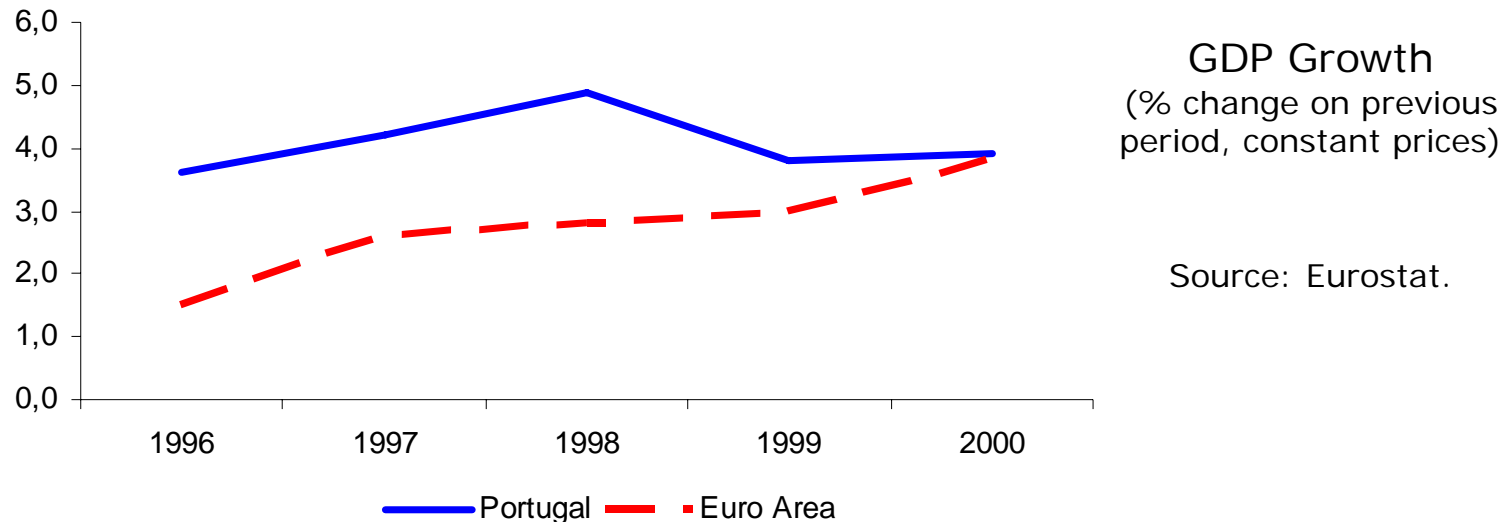
### Lisbon Agenda

- Focus on economic growth and employment
  - Concern for sustainability
  - Structural reforms (goods and services, financial and labour markets)
- Ideally, structural reforms should be implemented prior to entering EMU

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## Portugal: Run Up to Euro-Area Membership

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.



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## Portugal: Run Up to Euro-Area Membership

**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.

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## Portugal: The turn of the century

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**

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## Portugal: The turn of the century

### 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

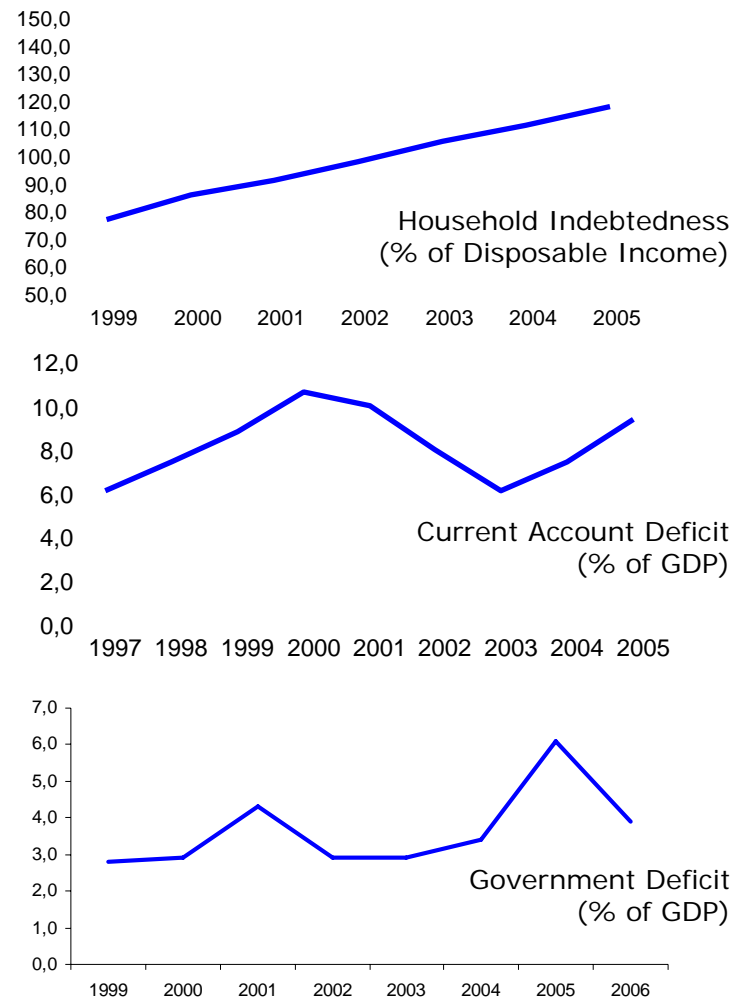


## Portugal: The turn of the century

### However...

#### Emergency of macroeconomic imbalances:

- **Private Sector Debt (households and firms)**, fuelled by a boom in credit lending founded in real collateral;
- **Current Account Deficit** – the rise in demand for tradable goods was not met by the domestic supply side and has largely leaked to outside;
- **Government Deficit** – although complying with the Maastricht criteria, the fiscal deficit was still large and the consolidation process was not based on strong structural measures on the expenditure side.



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## Portugal: The turn of the century

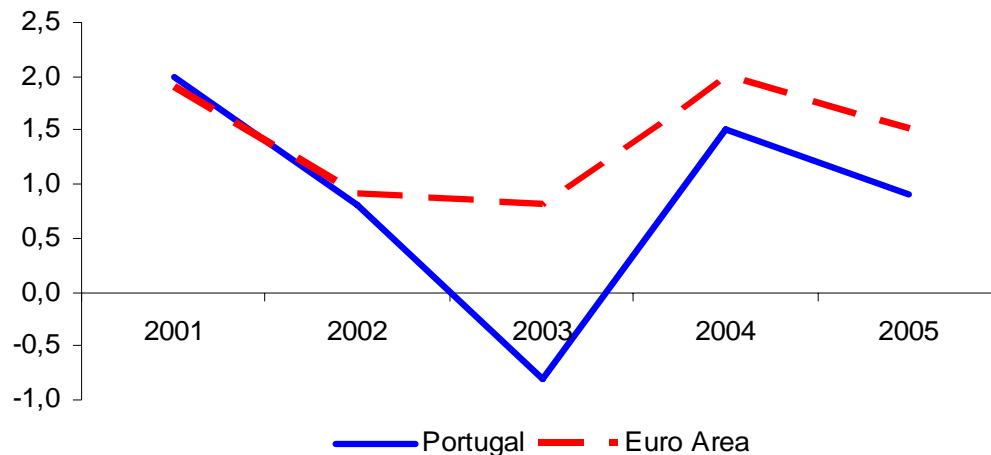
### Portuguese economy slowdown

	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.

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## The Portuguese National Reforms Programme

- 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

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## Signs of Recovery

	2005	2006	2007
GDP (% change on previous period)	0,9	1,3	1,8
Components of Growth			
Domestic Demand	1,6	0,3	1,7
External Balance (goods and services)	-0,7	1,0	0,1

Source: Eurostat.

- **Structural reforms are promoting economic and social development, by creating a favourable environment for entrepreneurship, productivity and economic growth**
- **Portugal's export product mix is moving steadily away from lower technology products towards medium and high technology goods (in 2007, for the first time, the share of high and medium-high technology goods was higher than the share of low and medium-low technology goods) with their target being redirected to new geographical markets outside the EU (such as USA, Angola, Singapore, Malaysia)**

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## Summary and Overall Lessons

### Lessons learned:

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;
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 we will have to wait longer for the results of reforms.
- The Lisbon Strategy has been proving a very useful framework for the design of structural reforms.

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## Way Forward: Lisbon Strategy and Quality of Public Finances 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