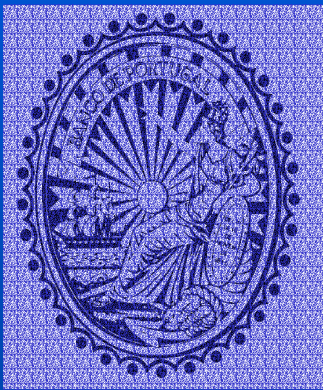

**What kind of policies should the
new Member States apply to
optimise their speed of
convergence ?**



Banco de
Portugal

VÍTOR CONSTÂNCIO
Brussels, 23 of April 2004

SUMMARY

I. INTRODUCTION

1. Benefits and conditions of successful integration
2. Situation of acceding countries. Problems and risks

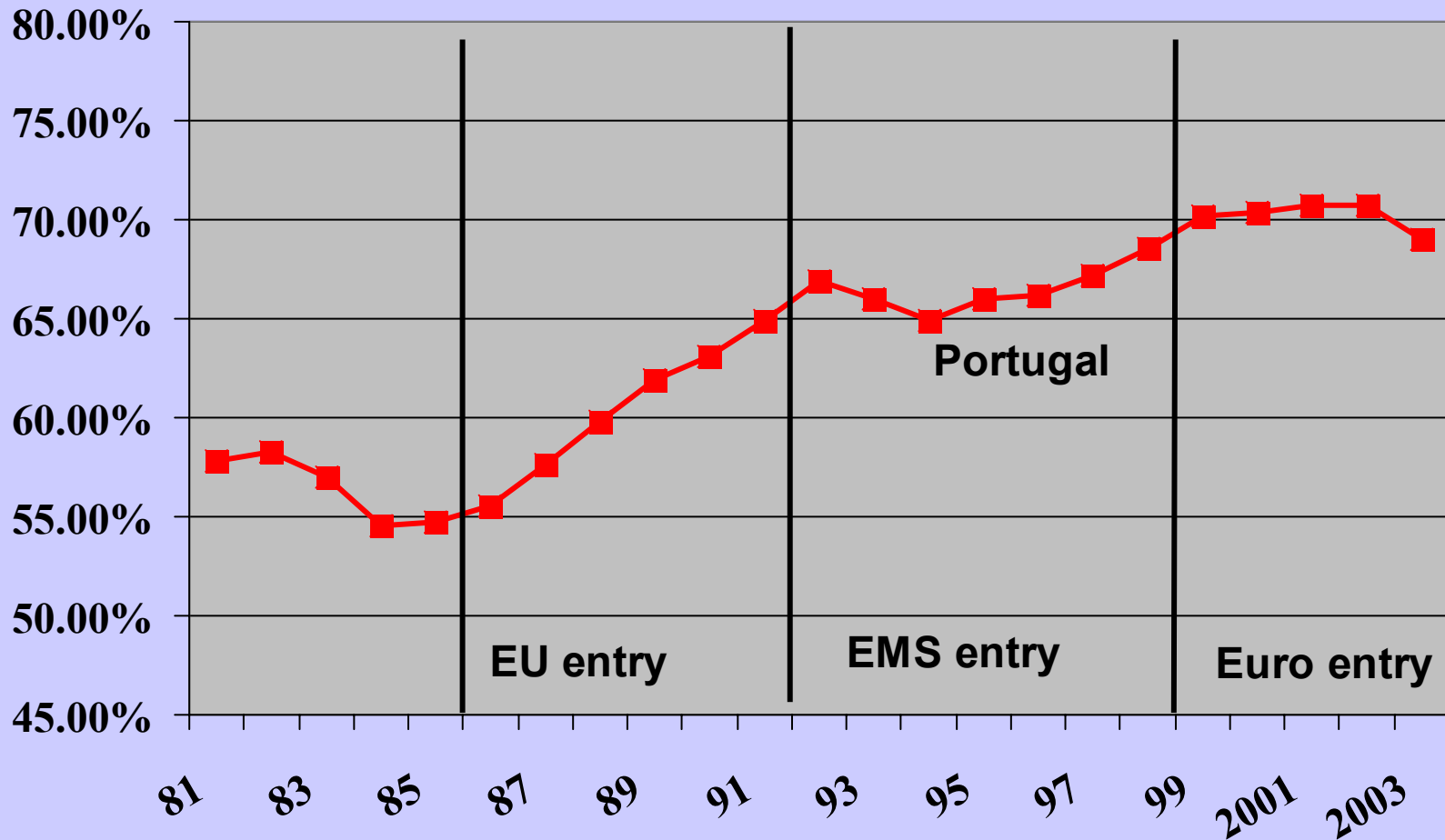
II ERM participation

1. The role of ERM and the portuguese experience
2. Interventions, interest rates and realignments
3. Credibility and fiscal policy

III. Monetary Union: risks and policy responses

1. Experience of overheating in Euro Area countries. An unavoidable adjustment to a new intertemporal equilibrium.
2. Inflation differentials in the Euro Area
3. Competitiveness and wage policy
4. Market driven demand booms and the external balance: the Portuguese case.
5. The role of fiscal policy and market based adjustments
6. Financial stability risks
7. Structural reforms and potential growth

GDP per capita (PPS in % of EU-15 average)



Source: Eurostat

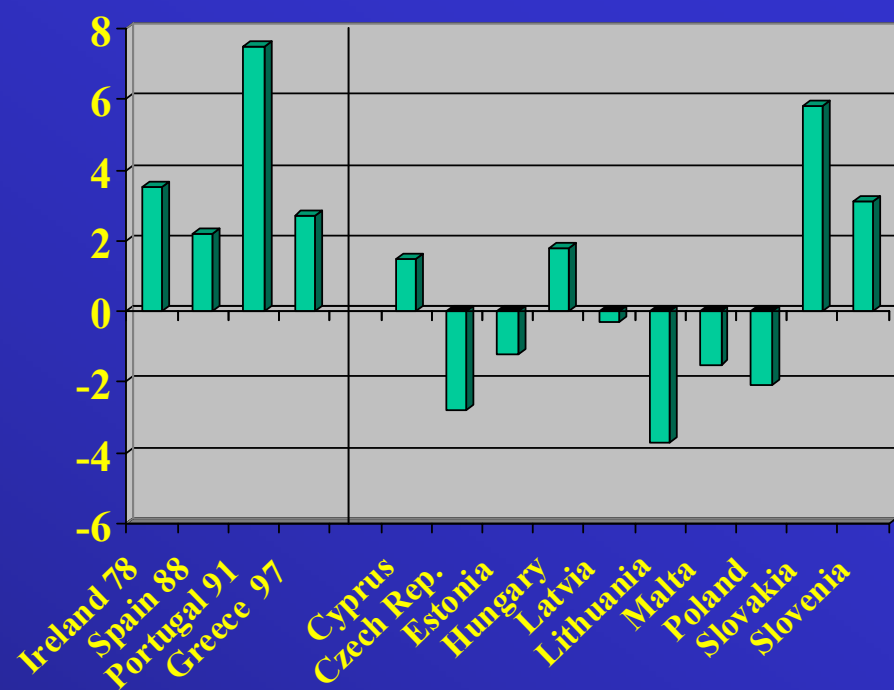
Benefits and conditions of successful integration

Conditions of successful integration:

- High degree of trade integration**
- Synchronization of economic cycles (similarity of economic structures, institutions...)**
- Good alternative mechanisms of adjustment:**
 - **flexible markets with flexible setting of wages and prices**
 - **anti-cyclical use of national fiscal policy**
 - **developed financial sector well integrated with the monetary area**
 - **people mobility**
 - **fiscal federalism**

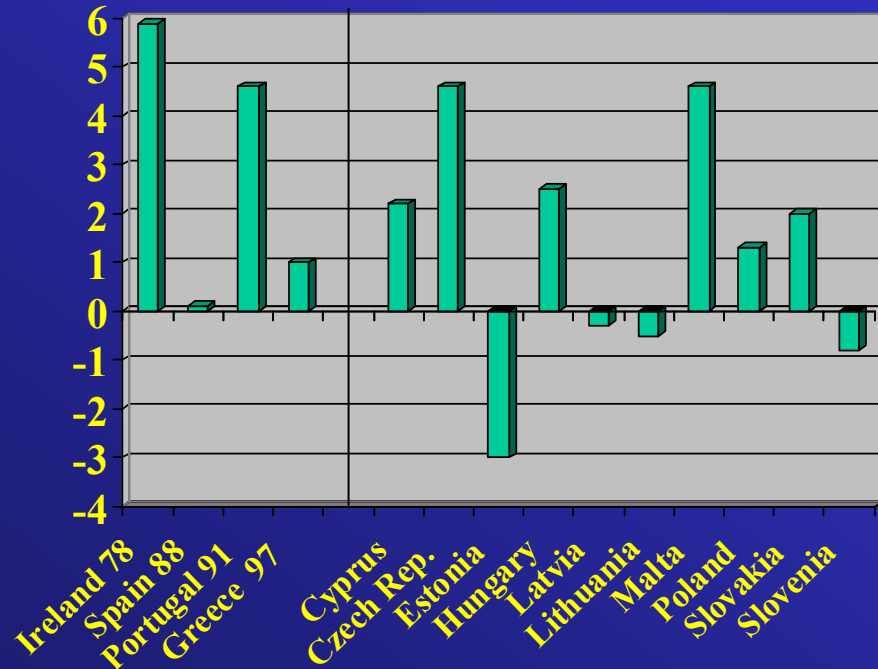
MAASTRICHT CRITERIA

**INFLATION: DIFFERENCES
TO THE REFERENCE
VALUES**



MAASTRICHT CRITERIA

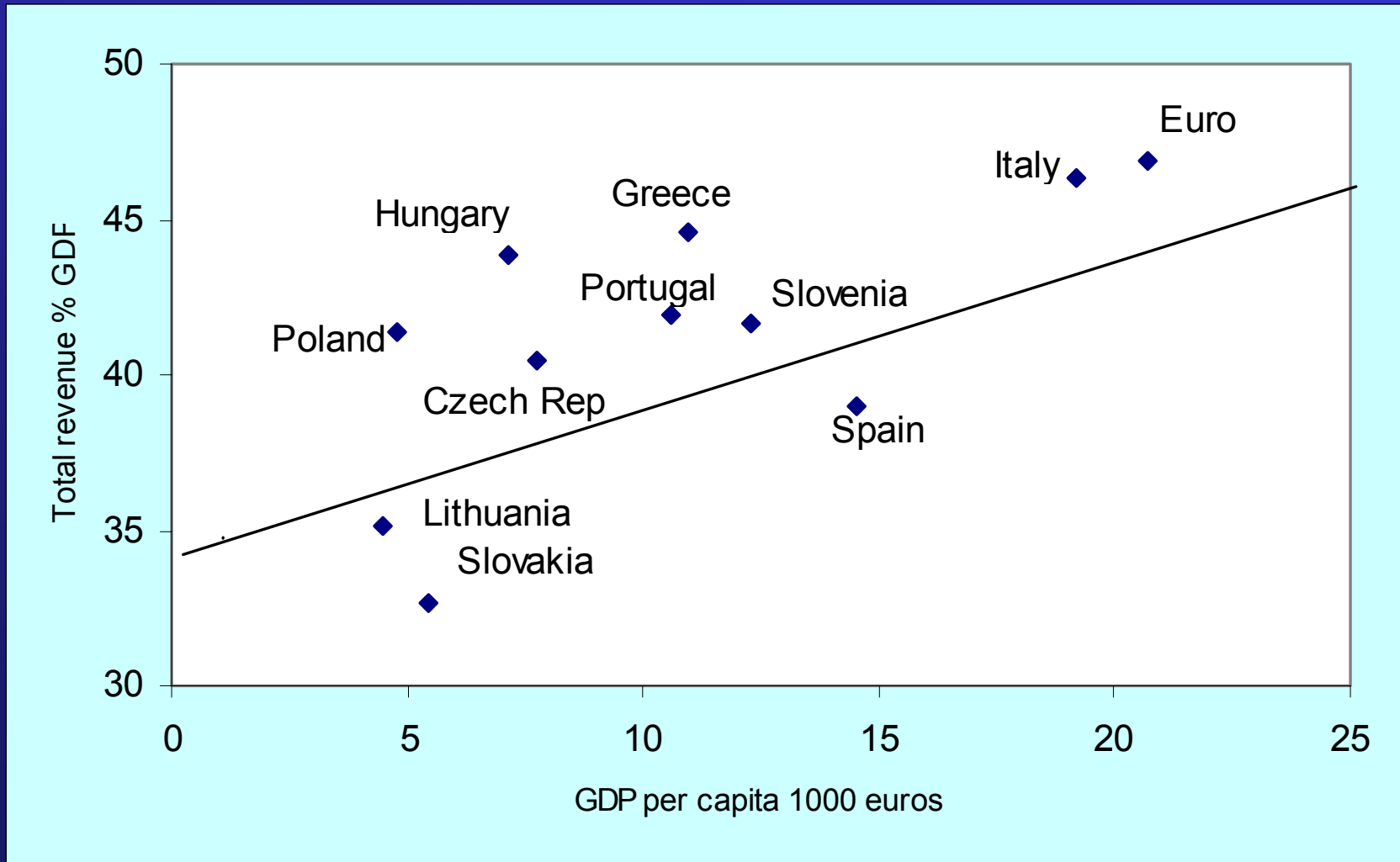
**BUDGET DEFICITS:
DIFFERENCES TO THE
REFERENCE VALUES**



	PRICE LEVELS AND INFLATION		
	Price levels (2001)	Inflation differentials with EU15 if price levels converge to Portugal's in (1)	
		5 years	10 years
EU-15 average	100.00		
Portugal 1991	73.9		
Czech Rep.	46.9	9.5	4.6
Estonia	51.2	7.6	3.7
Hungary	48.7	8.7	4.3
Latvia	47.9	9.1	4.4
Lithuania	52.1	7.2	3.6
Poland	60.9	3.9	1.9
Slovakia	42.1	11.9	5.8
Slovenia	66.6	2.1	1.1

(1) Source: OECD and De Nederlandsche Bank

Total revenue

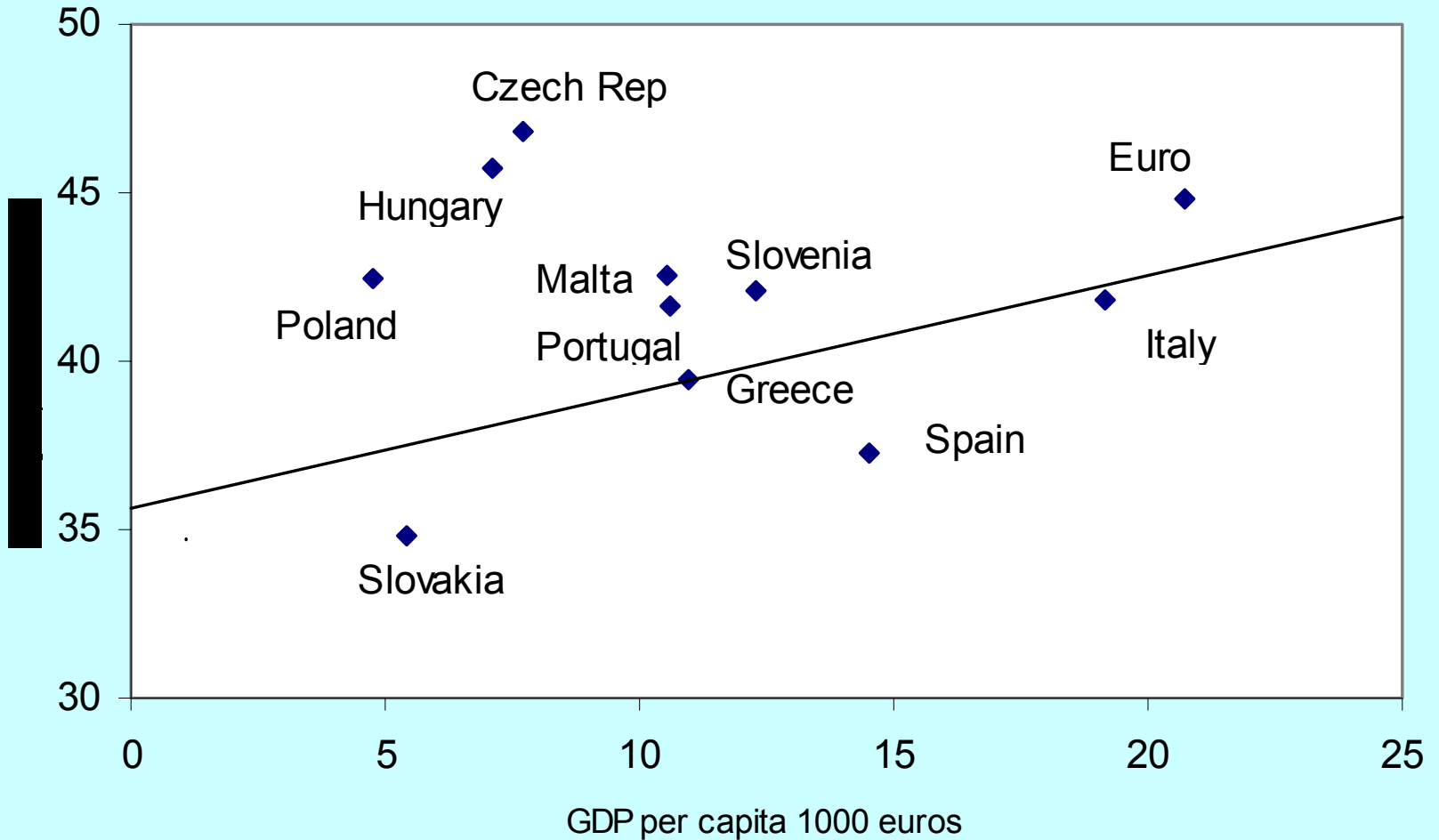


Source: AMECO Autumn 2003, BP calculations

Regression line based on OLS estimate over the 15 EU countries

For euro area countries average 1995-2003, for CEC's 2003 estimates

Primary expenditure



Source: AMECO Autumn 2003

Regression line based on OLS estimate over the 15 EU countries

For euro area countries average 1995-2003, for CEC's 2003 estimates

Potential problems and risks

- ❑ **Pressures for higher inflation. Strong Balassa-Samuelson effect. High growth dynamics and catching-up of price levels. Real appreciation above the equilibrium exchange rate.**
- ❑ **Possible real interest rate misalignment and consequent credit boom.**
- ❑ **Large capital inflows**

Main risks:

- o Boom and bust cycle with recession and hysteresis
- o Overheating in asset markets (housing and stock exchange)
- o Loss of competitiveness and current account unbalance
- o Financial stability risks

These risks may occur before and after the euro adoption. To optimize the speed of convergence countries must make proper use of ERM II participation, avoid the worse consequences of overheating and continue reforms to improve their growth potential and increase total factor productivity.

SUMMARY

I. INTRODUCTION

1. Benefits and conditions of successful integration
2. Situation of acceding countries. Problems and risks

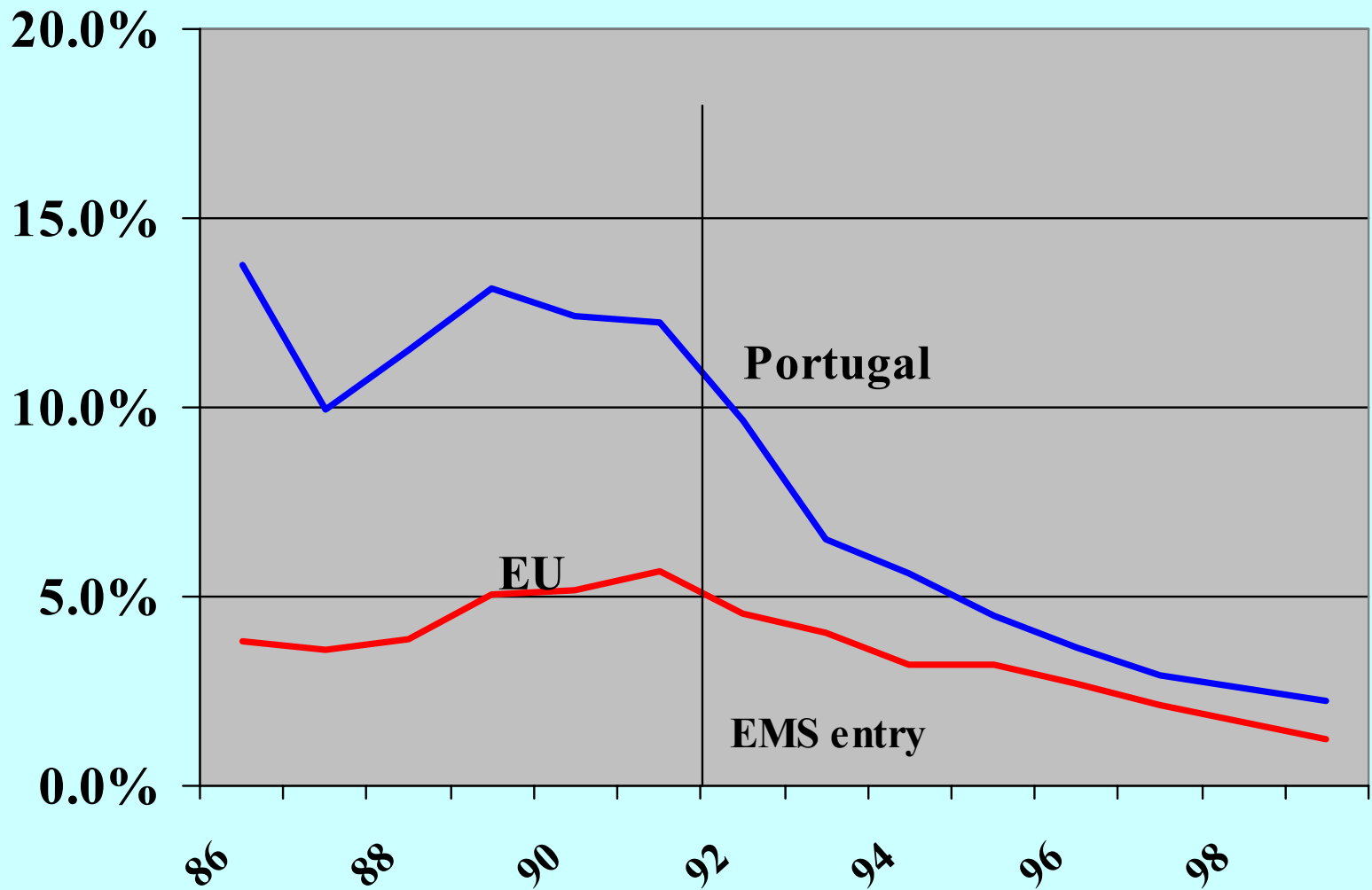
II ERM participation

1. The role of ERM and the portuguese experience
2. Interventions, interest rates and realignments
3. Credibility and fiscal policy

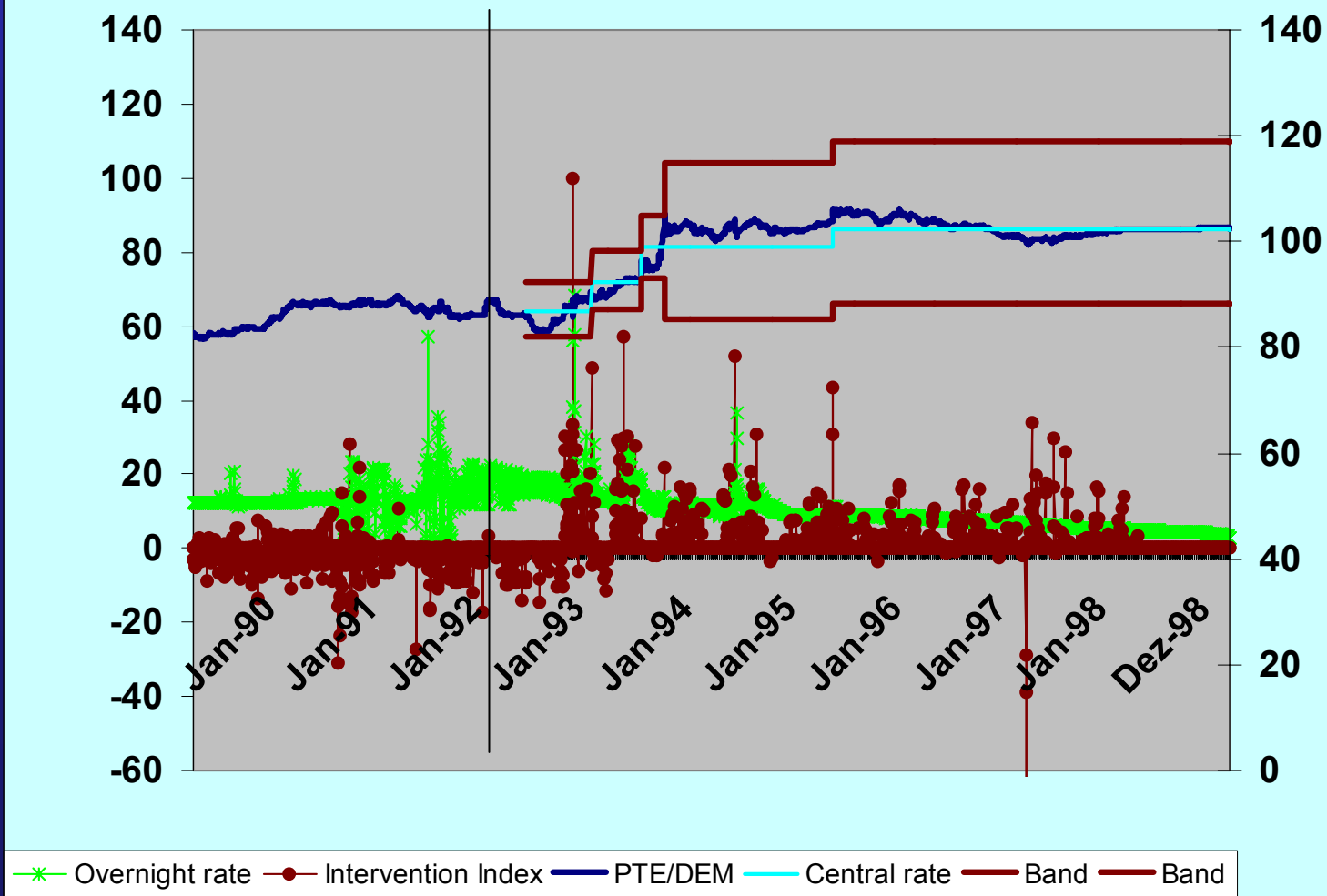
III. Monetary Union: risks and policy responses

1. Experience of overheating in Euro Area countries. An unavoidable adjustment to a new intertemporal equilibrium.
2. Inflation differentials in the Euro Area
3. Competitiveness and wage policy
4. Market driven demand booms and the external balance: the Portuguese case.
5. The role of fiscal policy and market based adjustments
6. Financial stability risks
7. Structural reforms and potential growth

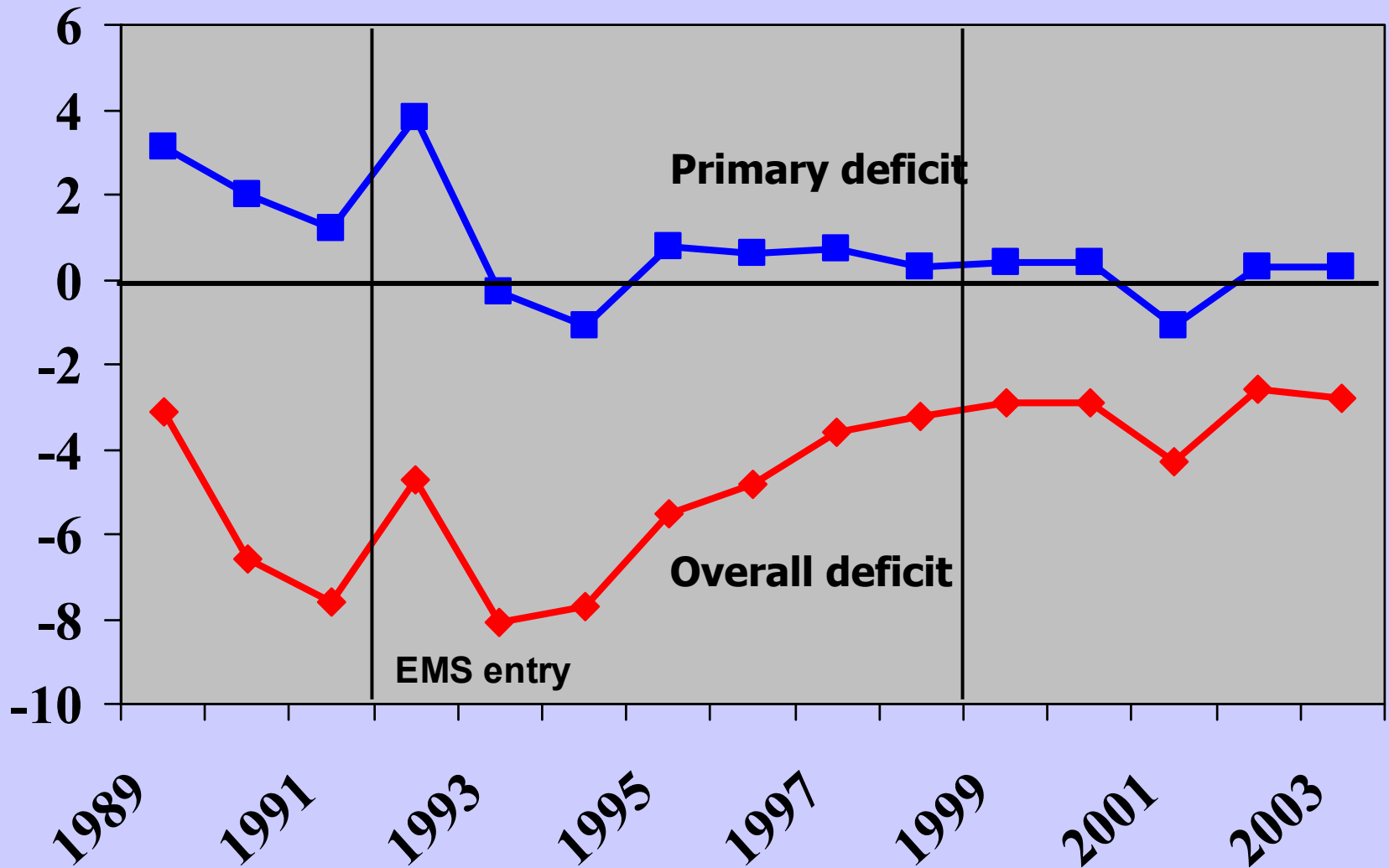
INFLATION



Escudo Exchange Rate v. the Deutsche Mark, Interventions and the Overnight rate



Budget Deficits in % of GDP



Successful and flexible use of ERM

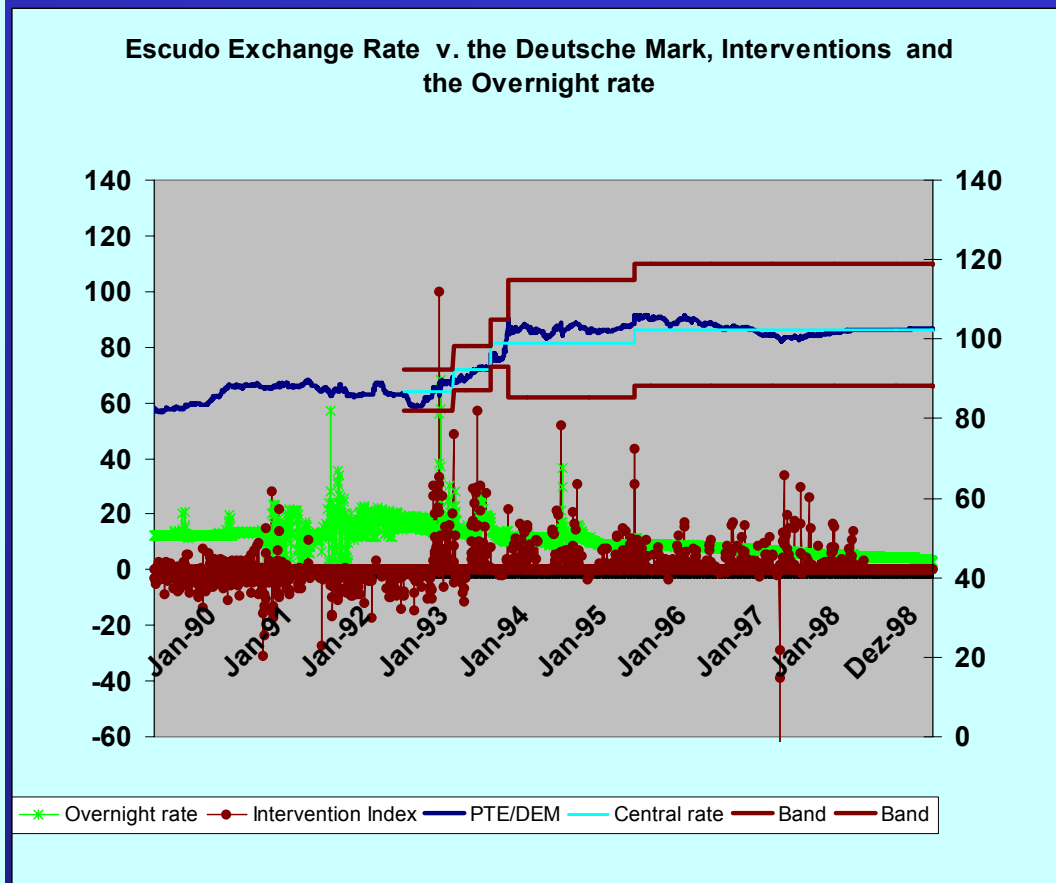
- Determined and simultaneous use of interventions and interest rates with a sense of the primacy of the exchange rate objective

- During the period there were 2,4% of days with active intervention with 91,5% of success.

- Flexible use of realignments that offset initial real appreciation and did not affected the disinflation process. Central rate was not seen as future conversion rate.

- The escudo stayed a long period in ERM gaining stability as policies gradually made the target of adopting the euro more credible. There was a disciplinary effect.

- The initial success with disinflation was helped by very high real interest rates and by the the european recession of the early 90's. During the first years of ERM participation there was no demand or credit boom



Source: Adão A. and J. Pina (2003) Boletim Económico B.P, June.

SUMMARY

I. INTRODUCTION

1. Benefits and conditions of successful integration
2. Situation of acceding countries. Problems and risks

II ERM participation

1. The role of ERM and the portuguese experience
2. Interventions, interest rates and realignments
3. Credibility and fiscal policy

III. Monetary Union: risks and policy responses

1. Experience of overheating in Euro Area countries. An unavoidable adjustment to a new intertemporal equilibrium.
2. Inflation differentials in the Euro Area
3. Competitiveness and wage policy
4. Market driven demand booms and the external balance: the Portuguese case.
5. The role of fiscal policy and market based adjustments
6. Financial stability risks
7. Structural reforms and potential growth

II. 1. Experience of overheating in Euro Area countries. An unavoidable adjustment to a new intertemporal equilibrium.

The change of regime with the adoption of the euro:

- Increased substitutability of financial assets**
- Consolidated reduction of the cost of capital**
- Increase in wealth and reduced liquidity constraints**
- Different meaning of the current account and primacy of credit risk.**

These features create the conditions for demand/credit booms and possible overheating.

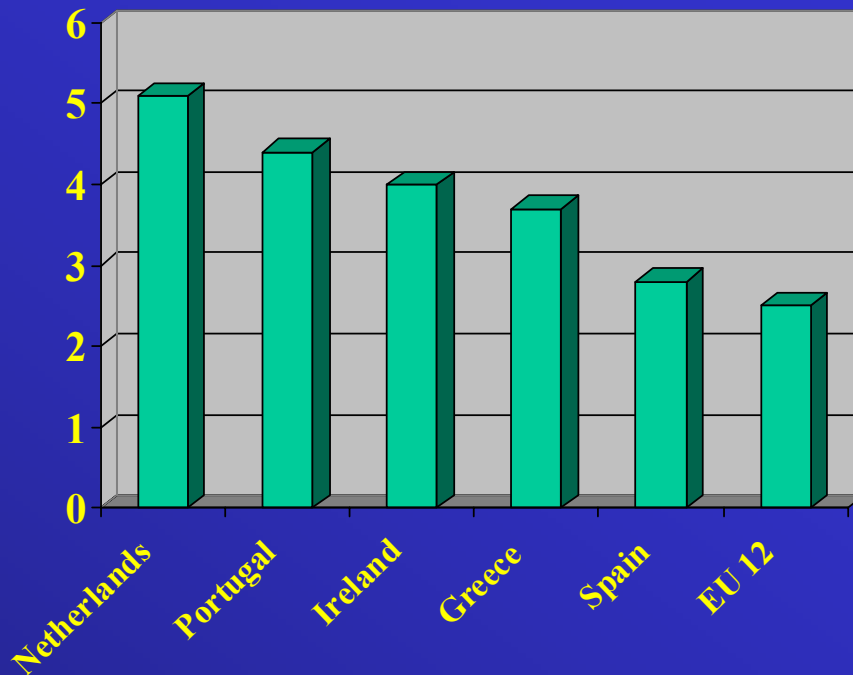
- The drop in interest rates increases wealth, reduces liquidity constraints and favours consumption intertemporal smoothing.**
- The reduction of the cost of capital and the prospects of higher growth as a result of goods markets integration, lead to investment growth**

The counterbalancing policies are:

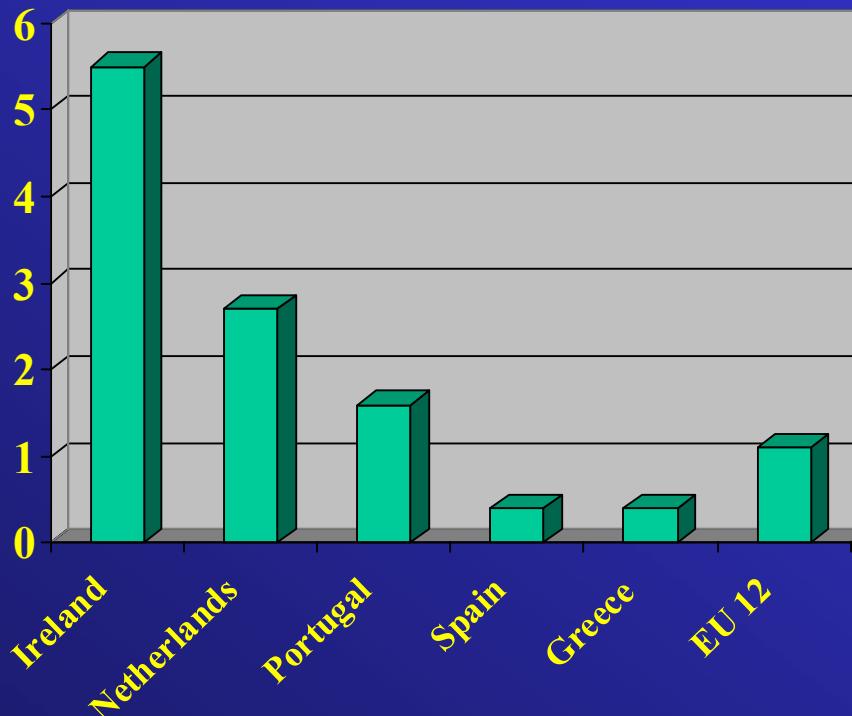
Anti-cyclical use of Fiscal Policy; Realistic wage policy; Good Prudential Supervision; Flexible and competitive price setting mechanisms

**Experience of overheating
in Euro Area countries.**

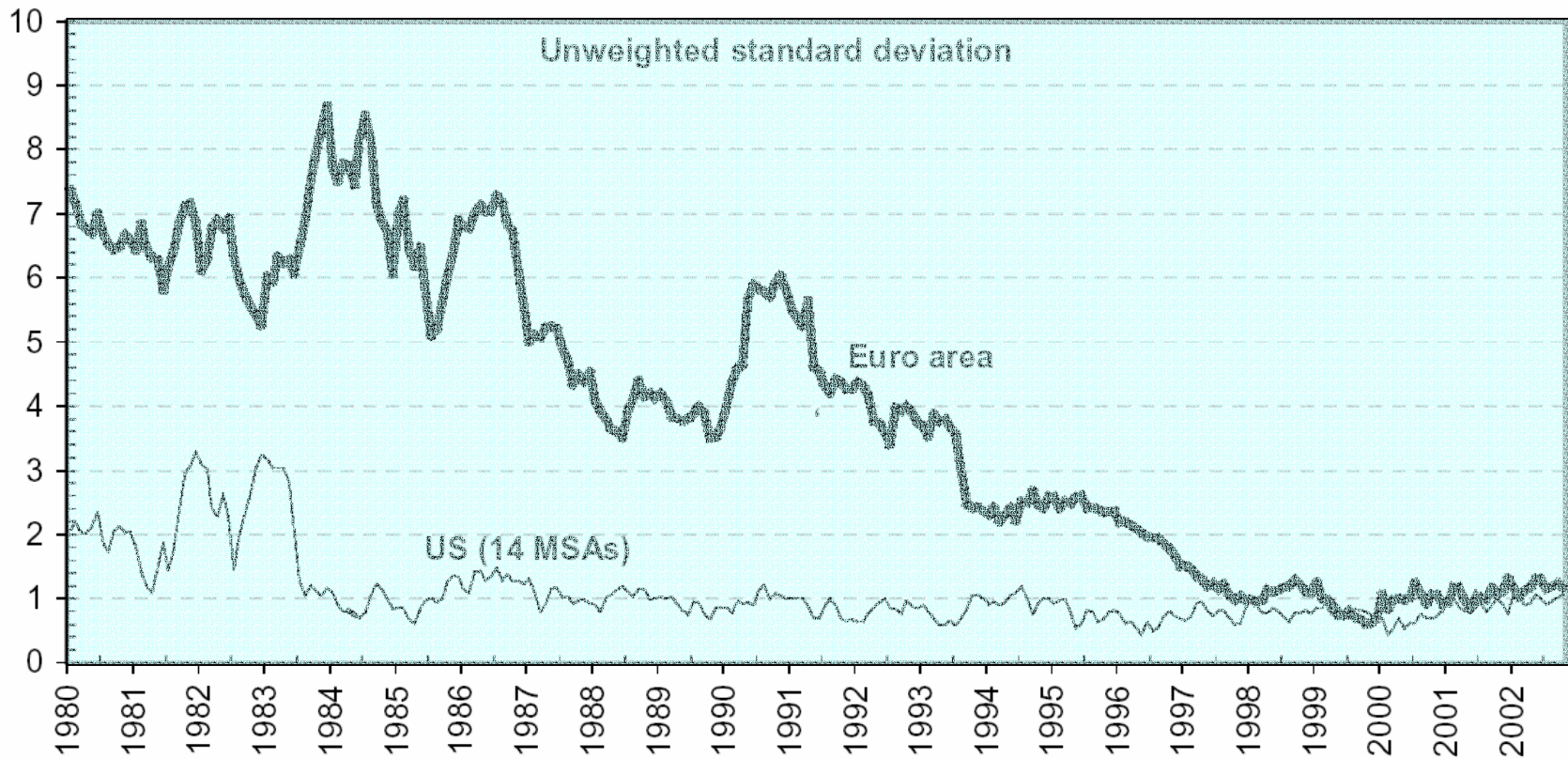
Inflation (2001)



Output gap (2001)



Inflation dispersion in the Euro Area and the USA

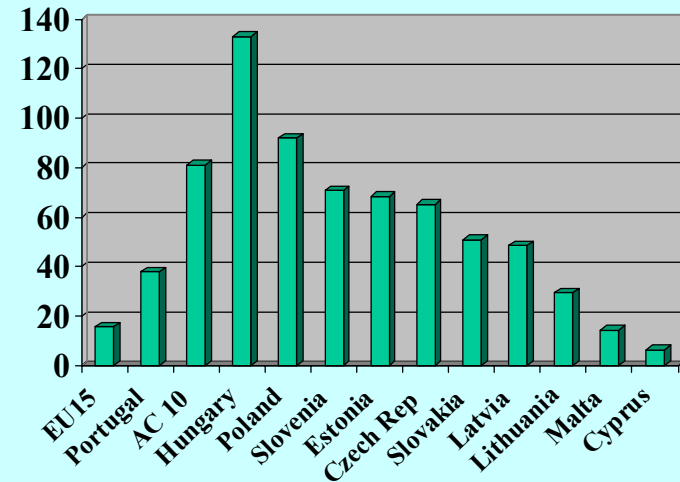


Source: ECB

Unit Labour Costs developments and incomes policy

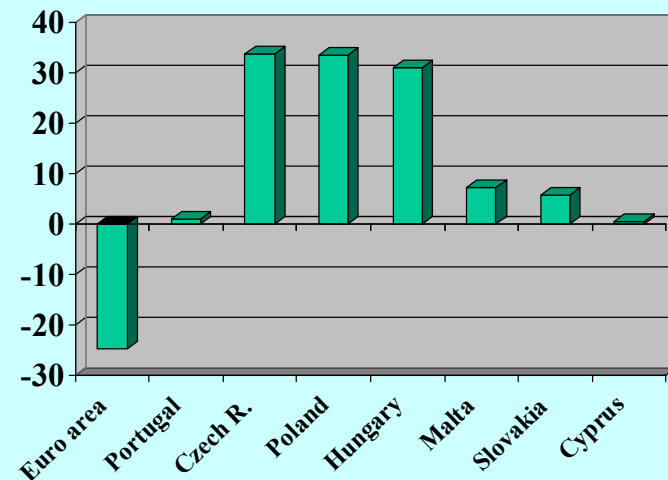
- Trends for higher inflation should not be aggravated by wage developments that could lead to a loss of competitiveness. In a monetary union the adjustment variable would be unemployment.
- Necessary to apply adequate guidelines for wage negotiations:
 - a) wage growth differentials with the euro area should not deviate much from the differential in real productivity growth.
 - b) wage negotiations valid for two years (stability of contracts)

Nominal Unit Labour Costs (increase in % since 1995)



Source: European Commission,
Economic Forecasts, Spring 2004

Real Effective exchange rate (increase in % since 1995)



Source: IMF, IFS

SUMMARY

I. INTRODUCTION

1. Benefits and conditions of successful integration
2. Situation of acceding countries. Problems and risks

II ERM participation

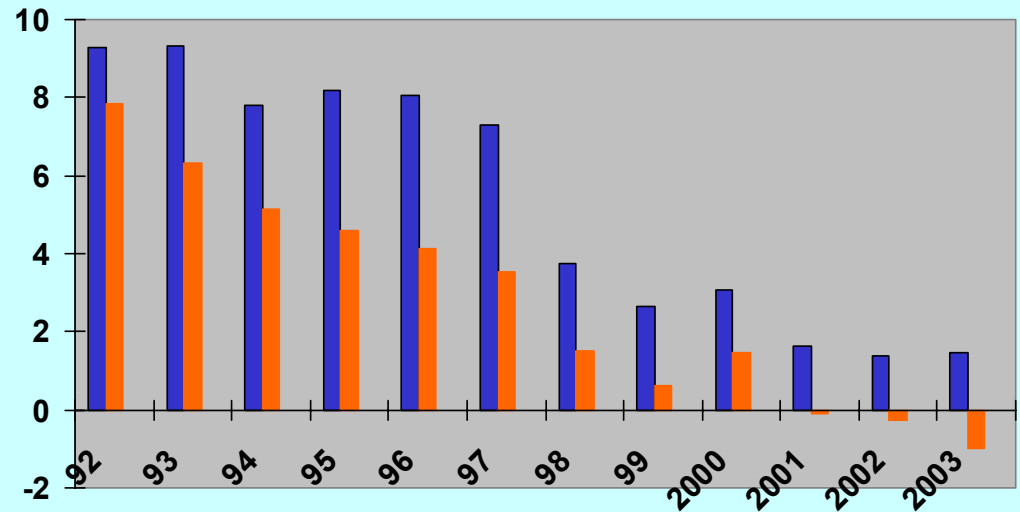
1. The role of ERM and the portuguese experience
2. Interventions, interest rates and realignments
3. Credibility and fiscal policy

III. Monetary Union: risks and policy responses

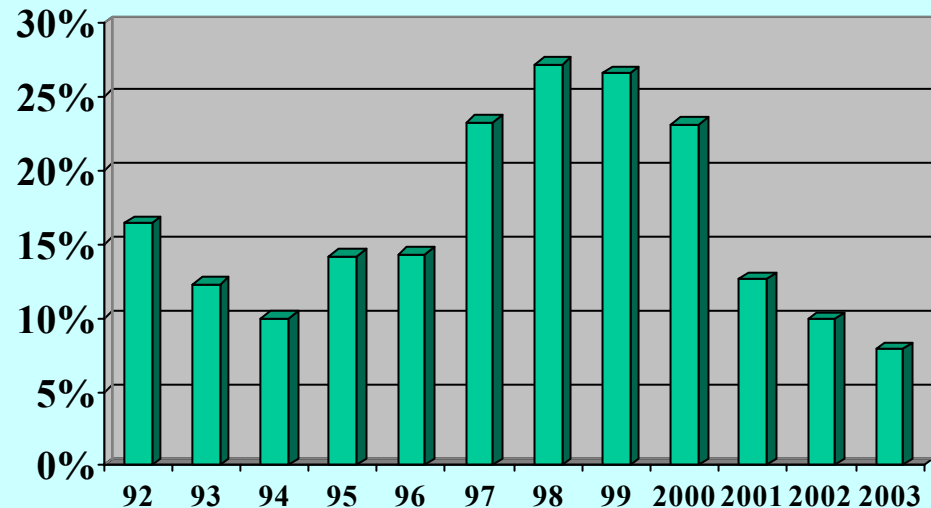
1. Experience of overheating in Euro Area countries. An unavoidable adjustment to a new intertemporal equilibrium.
2. Inflation differentials in the Euro Area
3. Competitiveness and wage policy
4. **Market driven demand booms and the external balance: the Portuguese case.**
5. The role of fiscal policy and market based adjustments
6. Financial stability risks
7. Structural reforms and potential growth

A credit boom developed after the drop in real interest rates became significant and was seen as permanent as participation in Monetary Union grew more certain.

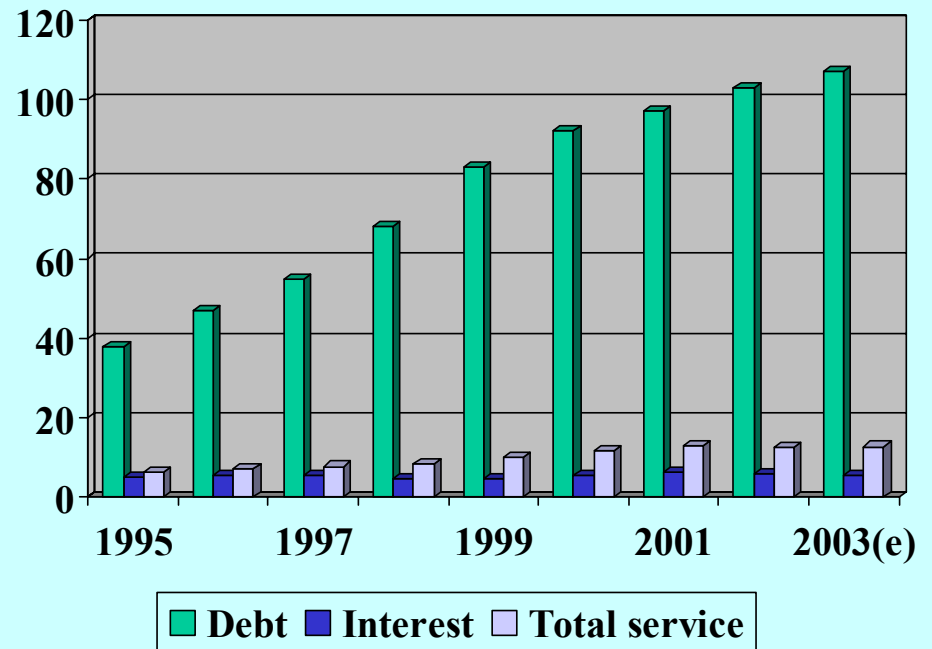
Portugal: Short and Medium term real interest rates



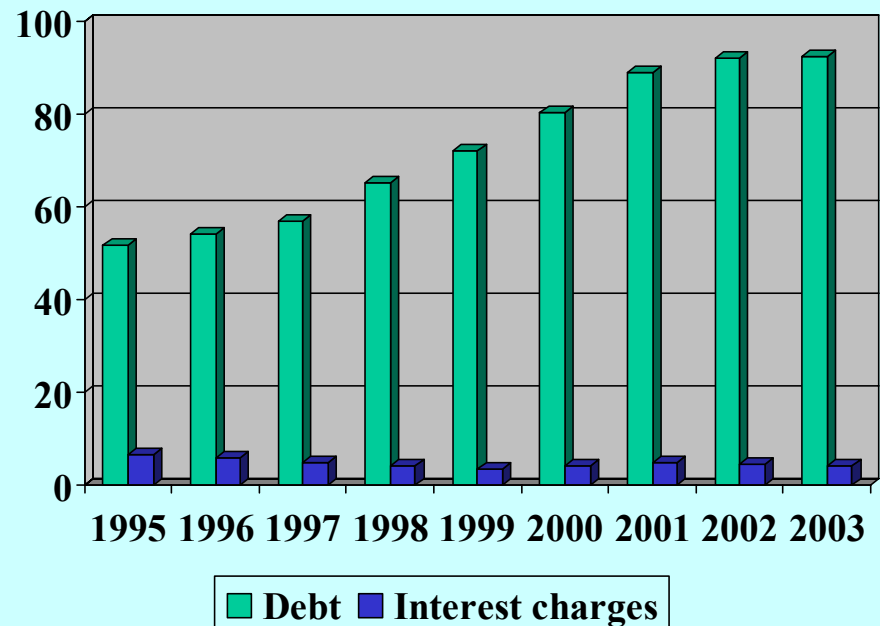
Portugal: Credit to the Private Sector (Annual growth rates)



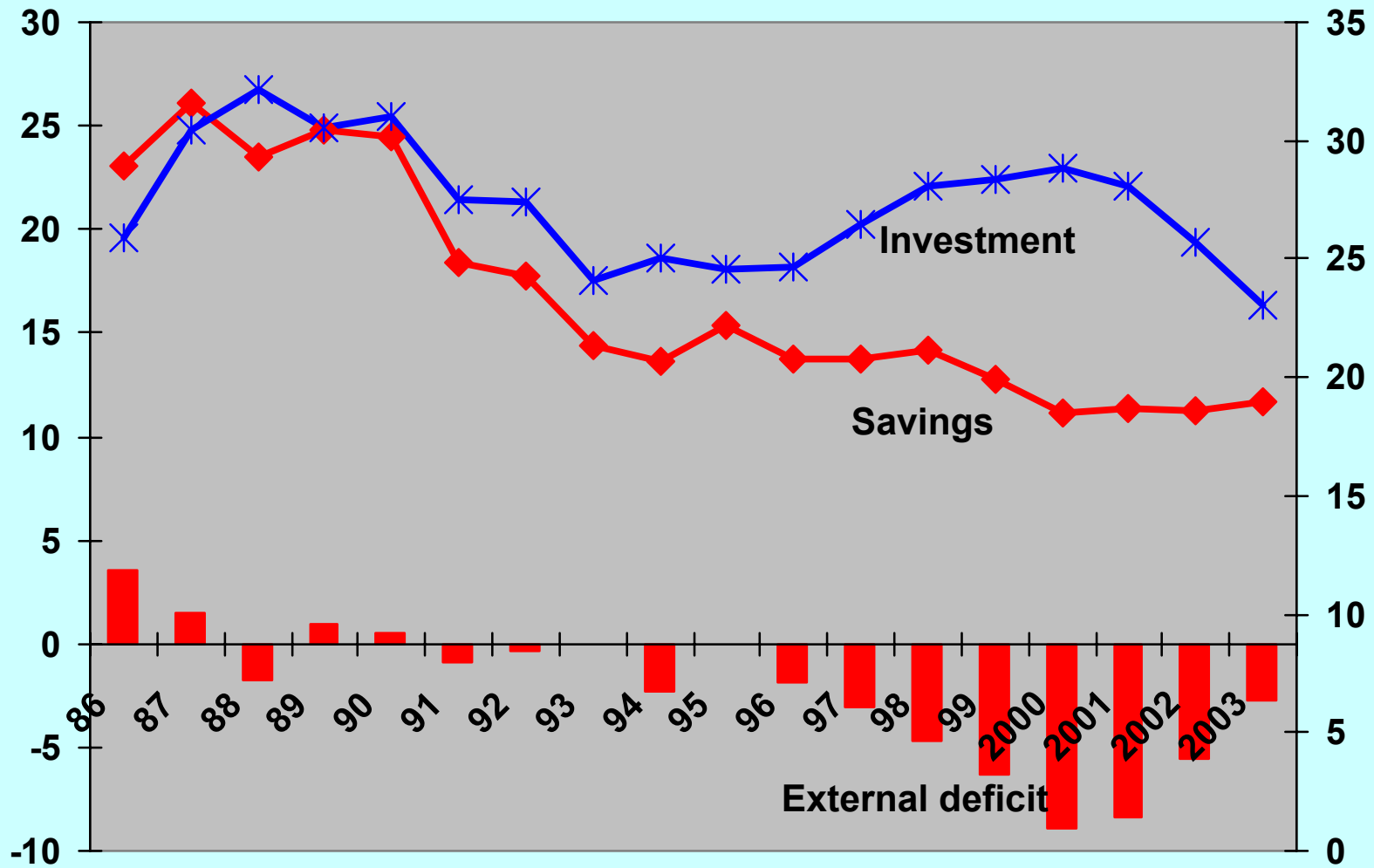
**Household debt,
interest charges and
total financial
charges in % of
Disposable Income**



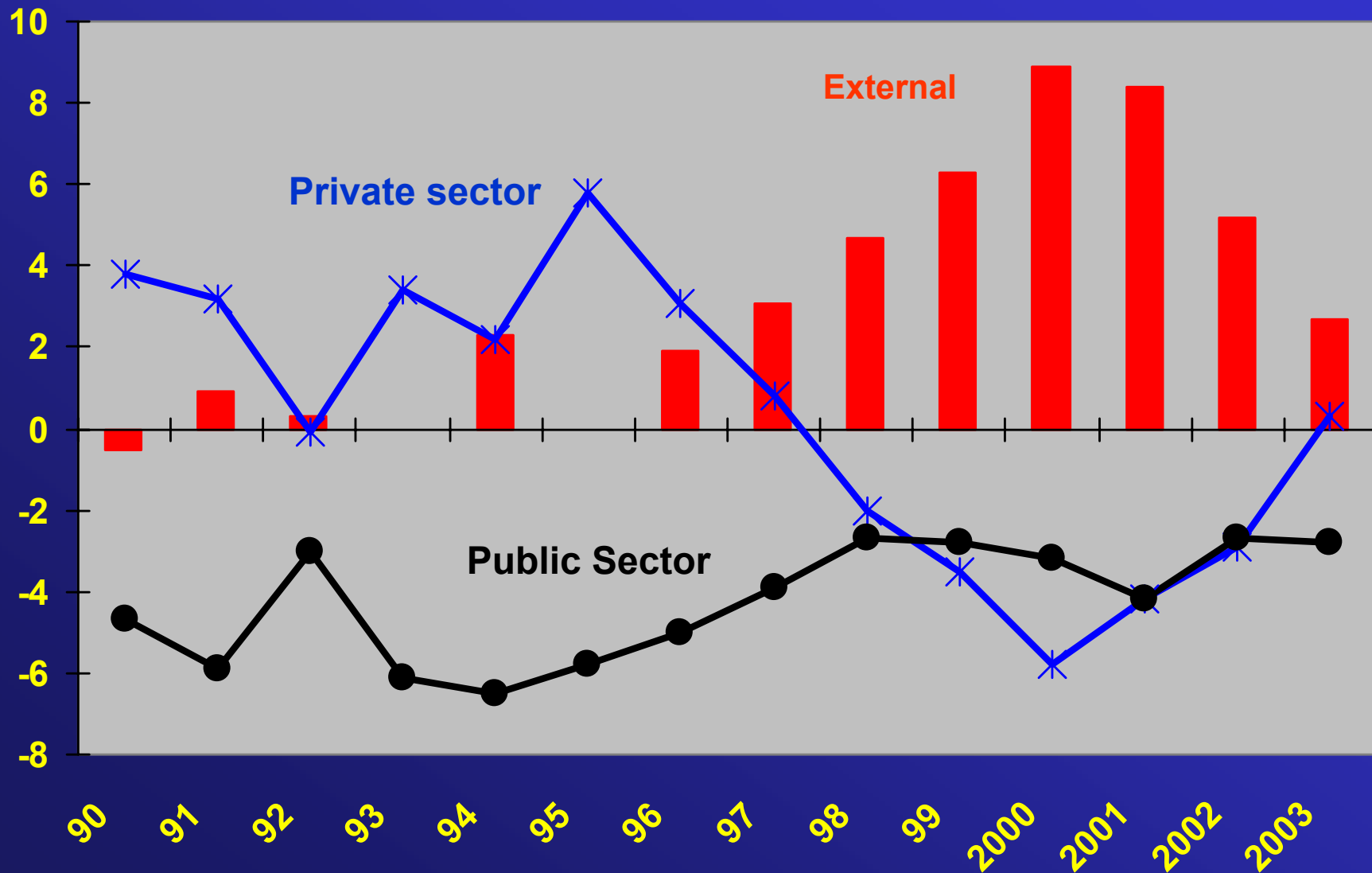
**Debt of Firms and
interest charges (%
of GDP)**



Portugal: Investment and Savings Rate (% of GDP)



Net lending (+) or Net Borrowing(-) by the Public, Private and External sectors

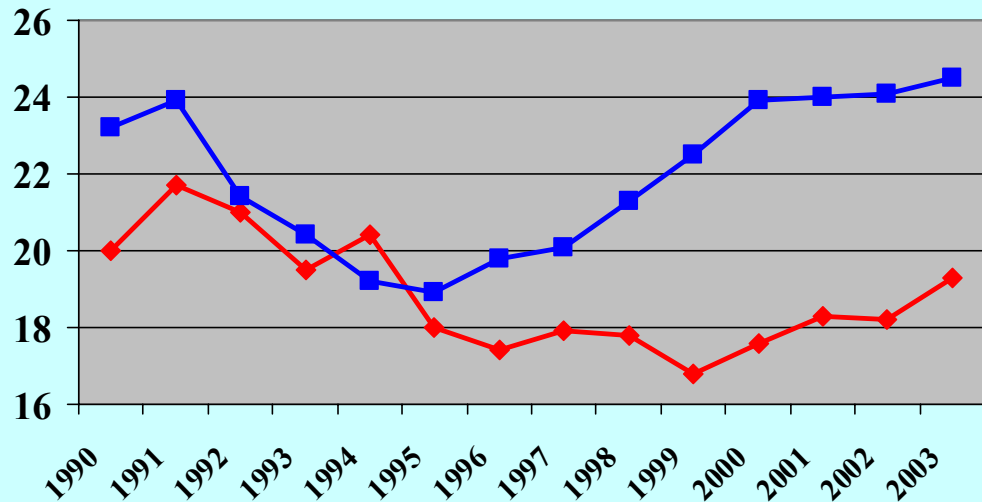


External = - (Current Account +Capital Account)

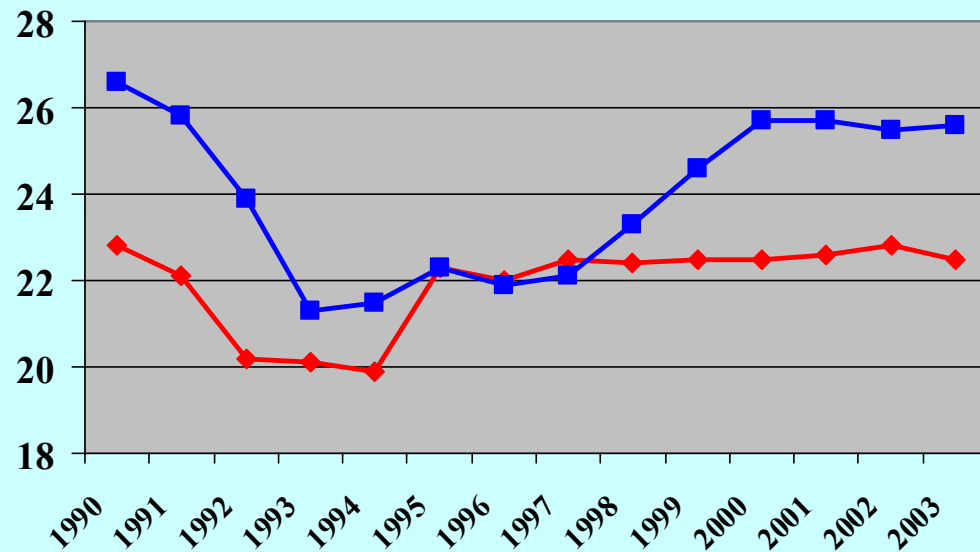
Adjustment to a new economic regime.

Investment and Savings (% of GDP).

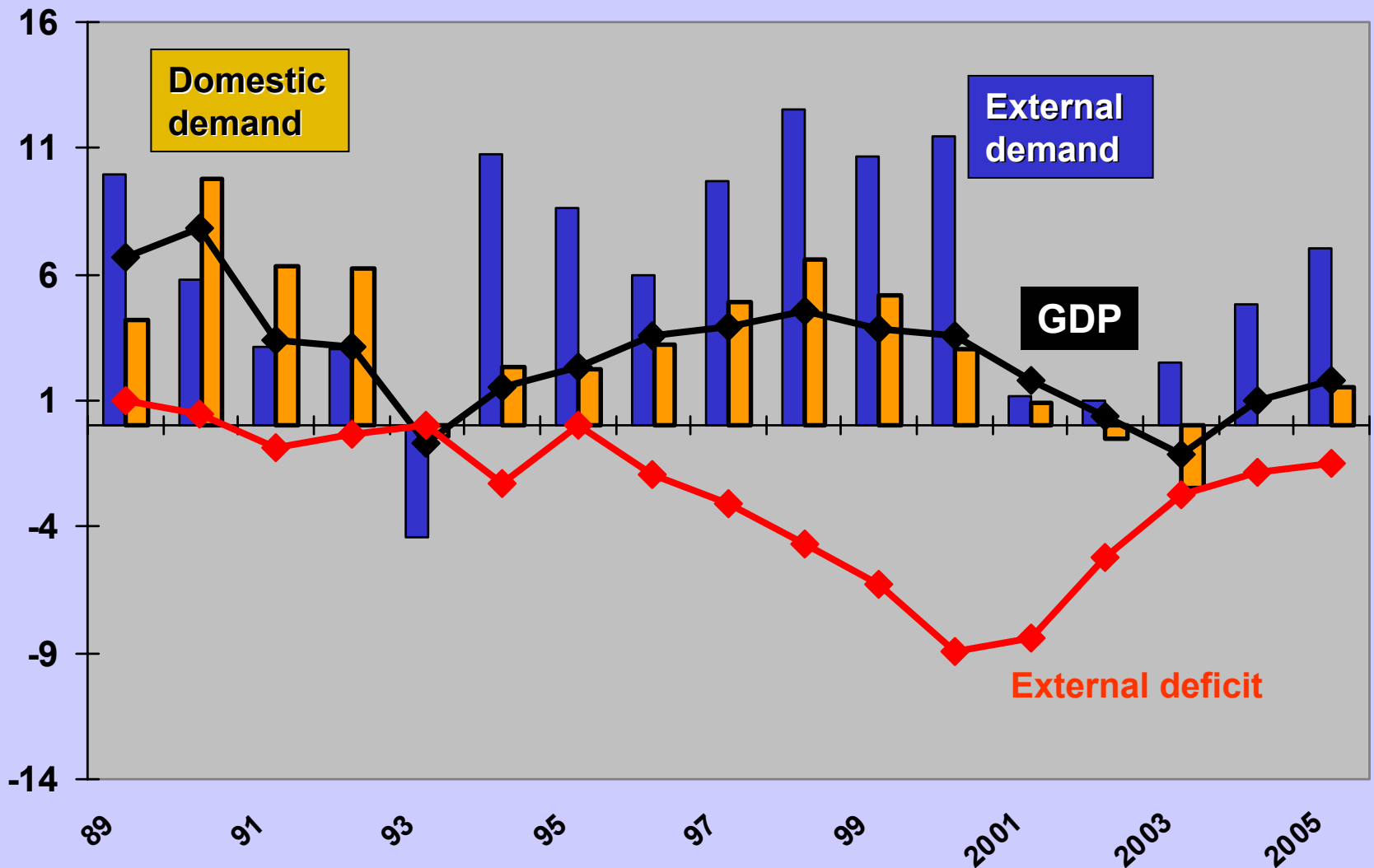
GREECE



SPAIN



GDP and Domestic Demand growth. Current Account in % of GDP



SUMMARY

I. INTRODUCTION

1. Benefits and conditions of successful integration
2. Situation of acceding countries. Problems and risks

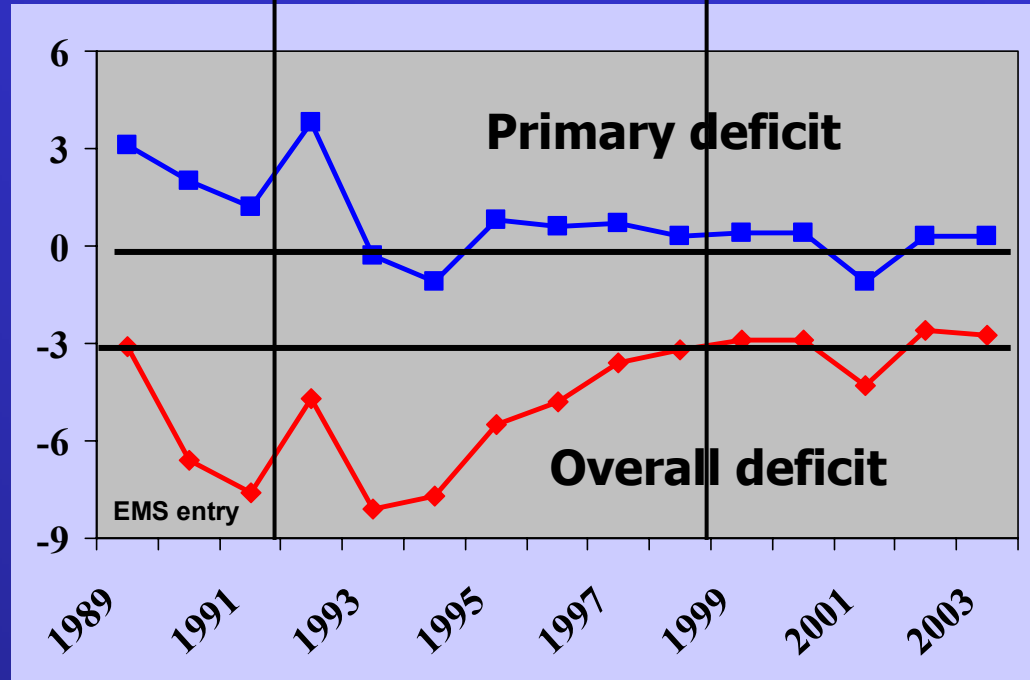
II ERM participation

1. The role of ERM and the portuguese experience
2. Interventions, interest rates and realignments
3. Credibility and fiscal policy

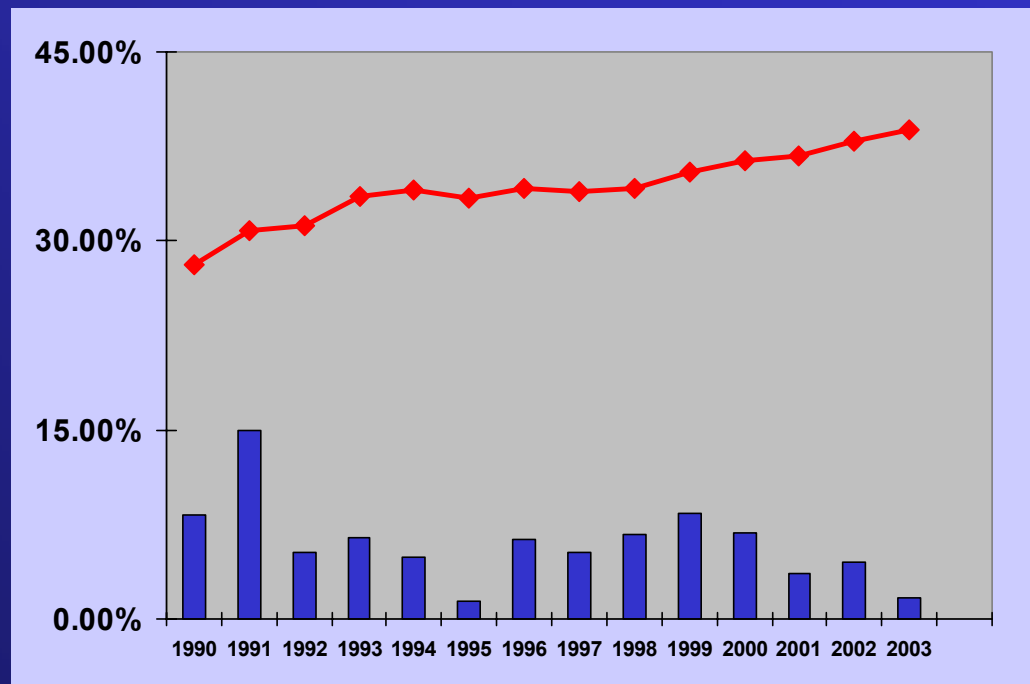
III. Monetary Union: risks and policy responses

1. Experience of overheating in Euro Area countries. An unavoidable adjustment to a new intertemporal equilibrium.
2. Inflation differentials in the Euro Area
3. Competitiveness and wage policy
4. **Market driven demand booms and the external balance: the Portuguese case.**
5. **The role of fiscal policy and market based adjustments**
6. Financial stability risks
7. Structural reforms and potential growth

Budget Deficits in % of GDP



Current Primary Expenditures (% of GDP and real growth rates)



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 n° 323, Feb 2002

«Simulations suggest that market based adjustments is fairly rapid in the small economies in returning demand shocks to baseline. In this respect, deeper integration (stronger trade linkages, greater migration and an anchoring of expectations in area wide inflation) would help to smooth adjustment.

.... Concerning fiscal policy, the automatic stabilisers help to smooth the impact of a demand shock, but only to a limited extent and the fiscal multipliers are fairly small in open economies. 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.

(P. Hoeller et al. (2002) “Overheating in small euro area economies: should fiscal policy react ?” OCDE WP n° 323, Feb 2002)

Simulation of a reduction of the Budget Deficit in 2 p. p. in 2001 by reducing expenditure from 1998 onwards

	Difference from base scenario
	Annual Growth rates
Primary expenditure	-2.8 p.p.
Real GDP	- 0.8 p.p.
Inflation	- 0.6 p.p.
	Deficit value in 2001
Current Account	-2 % of GDP (from 8 to 6 %)

DEMAND BOOMS AND THE ROLE OF FISCAL POLICY

2. 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 that the following points are important:

a) 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.

b) The structural deficit should not exceed the level compatible with the full play of the automatic stabilizers without breaching the 3% limit.

c) Introduce structural reforms early on to contain future budget pressures. Adopt efficient institutional procedures for the preparation and implementation of the budget. For instance, obtain multi-year expenditure commitments from Government and Parliament; or in view of the need to invest in infrastructure and the limitations of the Stability Pact that does not allow the use of debt over the cycle to finance those expenditures, prepare rules for PPP initiatives and project finance that ensure real transfer of risk, transparent accounting of multi-year commitments and limits to future expenditures.

DEMAND BOOMS, RISKS FOR INFLATION AND THE THE CURRENT ACCOUNT

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

2. Serious problems may, nevertheless, arise if the macroeconomic unbalances become sizable enough to create the following effects: a boom/bust economic cycle with significant recession and hysteresis; overheating in asset markets; loss of competitiveness resulting from excessive inflation and ULC misalignment; financial stability risks.

Portuguese consolidated Banking System

«Portuguese banks are well managed, have strong internal management systems and good credit risk management, and resemble their European counterparts in terms of product range, innovation, and sophistication.

... Portuguese banks have maintained sound and fairly consistent profitability throughout the economic cycle.»

(Standard & Poor's, April 2004, - Banking Risk Analysis: Portugal))

	2003
Total Assets in % of GDP	229 %
Transformation ratio (Credit /Deposits)	129 %
Cost/Income ratio	50.4 %
Non Performing Loans (% of total credit)	2.41%
Provisions in % of Non Performing Loans	107 %
Exposure to Emerging Countries (% of Assets)	1.7 %
Net Interest Income (% of Assets)	2.1%
Return on Assets (ROA)	0.81%
Return on Equity (ROE)	15.8%
Solvency Ratio	10.1 %

CONCLUSIONS

- 1. Adequate use of ERM II with a sense of the primacy of the exchange rate objective. Monetary policy cannot be conducted as a pure inflation targeting regime and that should be clear to the markets. The initial central rate should not be seen as the future conversion rate into the euro**
- 2. Permanent anti-cyclical use of Fiscal Policy, building-up a very solid and cautious position before joining the euro.**
- 3. Realistic wage policy to avoid excessive real appreciation in terms of relative Unit Labour Costs.**
- 4. Strong prudential supervision of the banking sector, taking seriously financial stability risks**
- 5. Implement structural and institutional reforms to ensure flexible and competitive markets.**
- 6. Continue to improve Institutions necessary to increase the rate of growth of potential GDP**