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The Path towards Economic and Monetary Integration: The Portuguese Experience

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1. Introduction

Portugal started its economic and financial integration process in 1960, when it became one of the founding countries of the European Free Trade Association (EFTA). Since then, significant structural changes have occurred, the economic integration process has deepened and the economy has achieved substantial nominal and real convergence to EU levels. Throughout the last four decades, despite important internal and external economic shocks, the path towards economic and monetary integration has been maintained and the economy has witnessed important changes in terms of trade partners, trade structure, structure of production and general macroeconomic environment. The economic and financial integration process is still underway but a major milestone was attained in 1999 with the participation in the group of countries that initiated the European Monetary Union (EMU). The relative success of the economic and financial integration process lies in a gradualist strategy and clearly defined objectives back-ed by a broad national consensus. In addition, the integration in the EU worked as a catalyst for economic reforms that would have otherwise taken longer to materialize.

The aim of this paper is to take a critical overview of the Portuguese experience since the sixties, with particular emphasis on the process of economic and financial integration with the EU. Such analysis allows us to identify the sequence of reforms, the obstacles posed by demand and supply shocks and to broadly evaluate the options that were made. This is a useful exercise both for Portuguese and foreign economic policy-makers, especially those of the Central and Eastern European countries, which are about to join the EU. First, to face the challenges ahead for the Portuguese economy it is necessary to focus on the areas where success was minor. Second, for countries about to enter the EU, which will probably face the same dilemmas experienced by Portugal, it is useful to assess past experiences.

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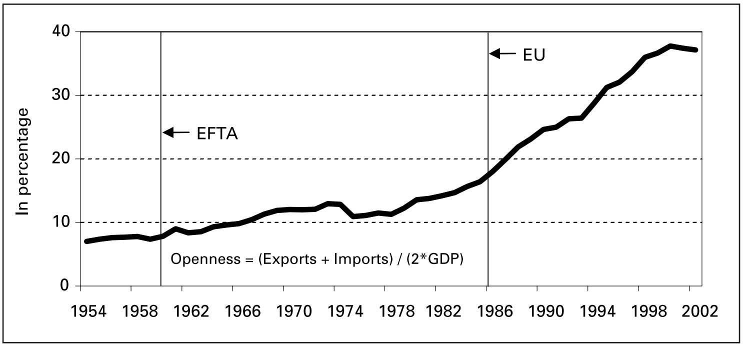
FIGURE 1 Degree of Openness (constant prices of 1995)



Source: AMECO

The paper is organized chronologically. In the next section we present the steps towards economic integration that were taken prior to EU accession in 1986. In section 3 we discuss the negotiation and the motivations for EU accession. In section 4, we analyse the period between 1986 and 1992, which coincided with the transitional phase negotiated by Portuguese authorities to adopt the EU trade regulations. Next, in section 5, we look at the so-called nominal convergence period, which laid the macroeconomic background that allowed EMU qualification in 1998 and the adoption of the euro in 1999. Section 6 discusses the present situation and identifies the challenges that lie ahead for the Portuguese economy. Finally, in section 7 we present some concluding remarks.

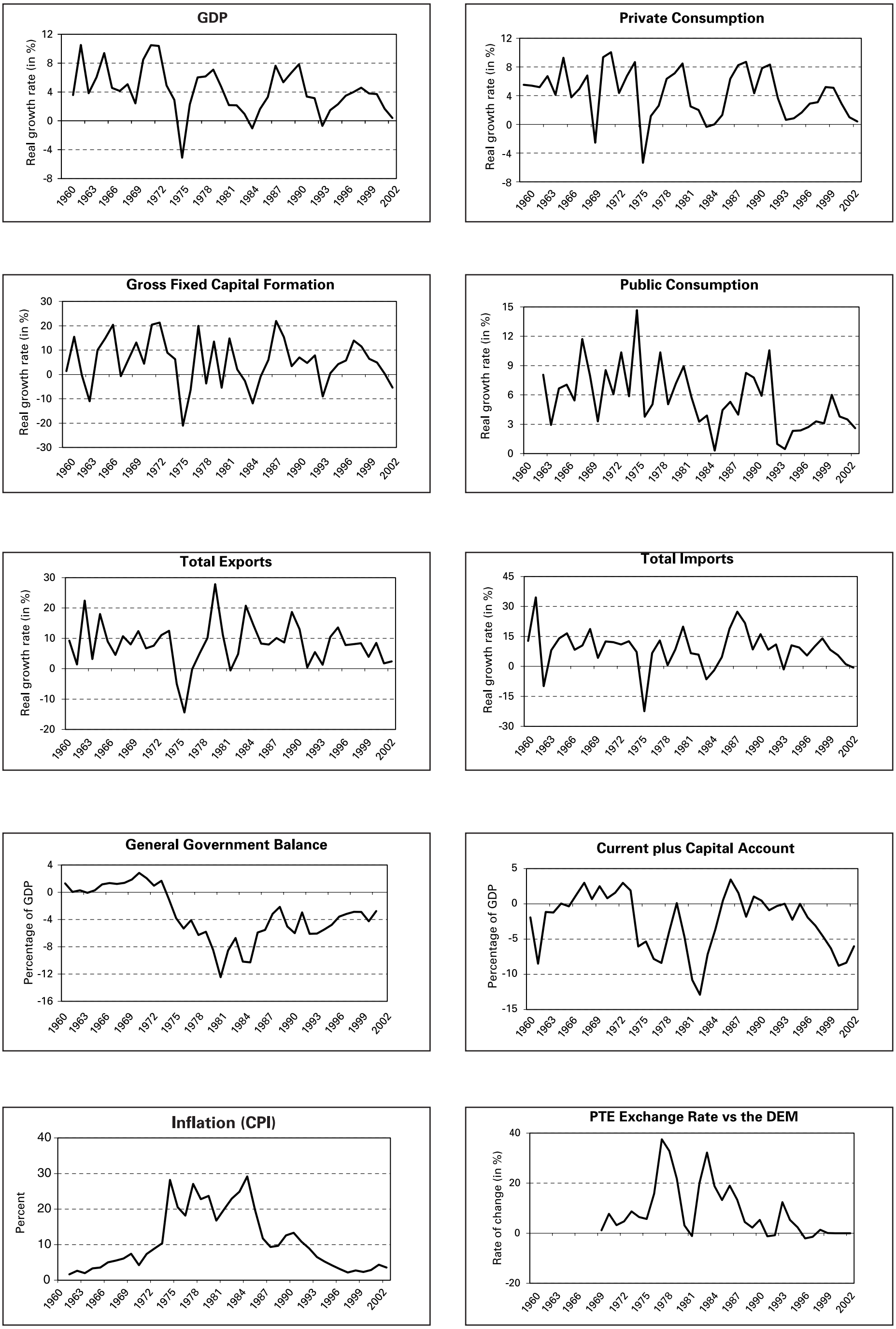
2. Before EU Entry

In 1960 Portugal was still a fairly closed economy and a closed society. A non-democratic regime had been ruling the country for already more than three decades, the manufacturing sector was underdeveloped, uncompetitive and protected from foreign competition and the trade flows were small relatively to the size of the economy (*Figure 1*).

The structure of production was based on manufacturing industry and services, agriculture still retained an important share of total employment and the price of the production factors was under the close control of the economic authorities. Therefore, interest rates, inflation and unemployment were low (*Figure 2*), to which also contributed the strong emigration flows to some European countries. The trade balance ran chronic deficits, partly due to the Portuguese external dependence on energy and food products. In addition, although the colonial war dragged on through the sixties, the budget deficits were kept mostly at below 2 percent of GDP.

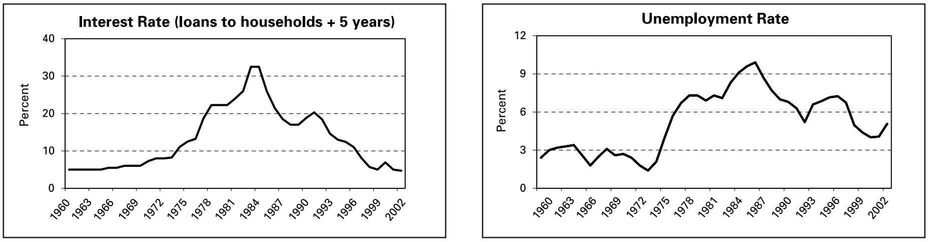
The decision to enter the EFTA was based on political and economical motivations. On economic grounds, the participation in a free trade zone like the EFTA was expected to initiate an export-lead industrialization process, contrasting with the import-substitution industrialization strategy that had been tried during the fifties and which had failed.

FIGURE 2 Main Macroeconomic Indicators in Portugal



(continued)

FIGURE 2 Main Macroeconomic Indicators in Portugal *(continued)*



Source: Banco de Portugal and INE

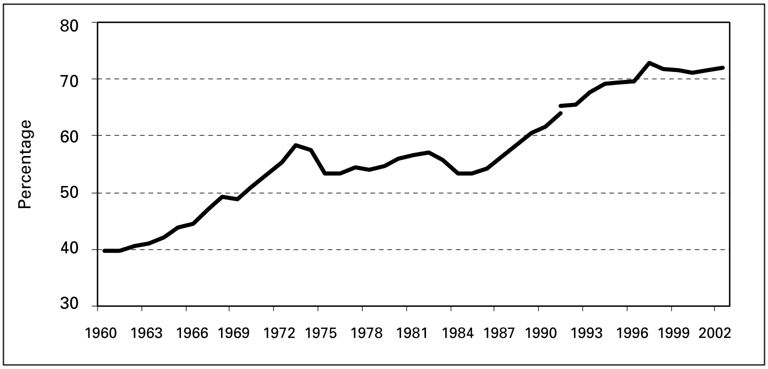
As the classic trade theory models predict, the engagement in free trade leads countries to specialize in the production of the goods where they have comparative advantage, which are typically those that intensively use the production factors relatively abundant in the country. Portugal was a relatively labour abundant country so it had comparative advantage in labour intensive goods. Indeed, during the sixties, the textiles, clothing and footwear industries strongly developed, benefiting from exports to the EFTA markets and foreign direct investment (FDI) inflows. Until the present, these industries have kept their export-oriented nature and remain a relatively important share of total exports (38 and 25 percent of merchandise exports in 1990 and 2000, respectively). In addition, the participation in the EFTA played an important role in establishing the know-how for the internationalisation of other industries. This strongly contributed to the sharp convergence of the GDP per capita to the European average witnessed during the sixties (*Figure 3*).

It is important to remark that, at this time, the option for entering the EEC instead of the EFTA did not exist. In fact, the non-democratic nature of the regime made it politically impossible. Furthermore, on economic grounds, given the structure of the Portuguese economy, entry into the EEC at this time would have probably been a too ambitious challenge.

Throughout the sixties, Portugal witnessed a strong emigration flow to certain European countries – representing cumulatively more than 10 percent of the population – which had important effects on the economy. First, it gave rise to substantial private unilateral transfers, which contributed to balance the current account. Second, such transfers increased households' savings and ignited the development of the banking system, through the expansion of bank branches out of the main cities. Third, the strong emigration, together with the colonial war, put a strain on the labour market, contributing to mounting wage and inflation pressures in the early seventies – see also (Sousa, 1995).

The beginning of the seventies brought about dramatic negative supply shocks to the Portuguese economy. The first negative supply shock occurred in 1973 with the sharp increase in oil prices. The first oil shock and the world recession that followed obviously had a severe negative impact on a small open economy like the Portuguese, much dependent on imported energy goods. In fact, the terms of trade sharply deteriorated and foreign demand reduced, negatively affecting the current account (Fi-

FIGURE 3 GDP per capita as a Percentage of EU-15 (PPP corrected)



Source: AMECO

gure 2). In addition, the inflation rate almost tripled from 1973 to 1974, reaching 28 percent. The second negative supply shock occurred in 1974–75, after the Portuguese revolution, which established democracy. In fact, the massive nationalization process in 1975 disrupted the management of firms, leading to loss of clients and decreasing profits. In addition, the unrealistically high nominal and real wage updates boosted unit labour costs and inflation. Then, owing to the existing instability and uncertainty, the transfers from emigrants sharply decreased and domestic capitals flew abroad. Finally, contrasting with the situation prior to 1974, the fiscal policy adopted a clearly expansionary stance (the general government deficit increased about 7 percentage points (p.p.) of GDP from 1973 to 1976). Despite these changes, the monetary policy remained unaltered with low administratively fixed interest rates and a relatively stable exchange rate against most European currencies. The third negative supply shock was the massive return of Portuguese nationals living in the former colonies, which abruptly increased the labour force and public expenditure. As a consequence of the three negative supply shocks, whose effects were mutually reinforced, and despite the political stabilization after 1976, serious macroeconomic imbalances mounted and the economy entered a phase of macroeconomic turbulence that lasted until 1985 – see also (Lopes, 1999).

Amongst the different macroeconomic imbalances, the current account deficit soon emerged as the most serious. The high inflation rates accompanied by stable nominal exchange rates implied real exchange rate appreciations and reduced export competitiveness. In addition, the international recession, the deterioration in the terms of trade (due to the first oil shock), the sharp decrease in tourism revenues and the drop in transfers from emigrants set the framework for a current account crisis.

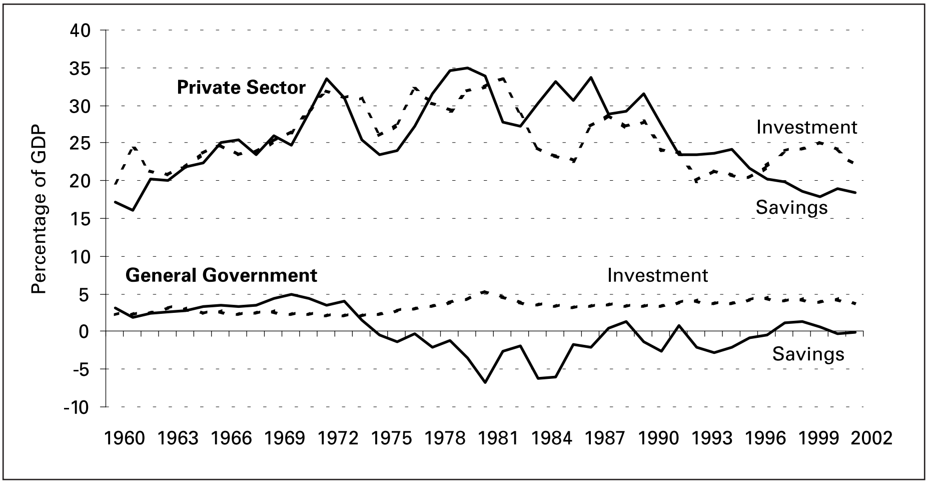
The current account imbalance was initially financed with foreign reserves but at the beginning of 1977 it became clear that the economy was on an unsustainable path and the monetary policy would have to change. During 1977 the Portuguese authorities adopted some corrective measures, namely increases in interest rates (first a 1.5 p.p. increase followed by another hike of 5 p.p.) and devaluations of the currency (first a spot devaluation of 15 percent and then the adoption of a crawling-peg with a monthly effective rate of depreciation of 1 percent). However, due to the usual lags (*J*-curve effect) these measures did not produce immediate results and the Portuguese government called for an economic stabilization agreement with the IMF. The economic stabilization agreement with the IMF worked in 1978–79 and was based on conventional expenditure-reducing and expenditure-switching policies.[1] This stabilization programme was successful since it corrected the foreign account imbalance without imposing a strong burden on economic growth. Nevertheless, the inflation rate remained high, fuelled by the continuing crawling-peg. The perceived success of the programme benefited from the expansion in the world economy, from the renewed entry of transfers from emigrants and from the lagged effects of the measures taken back in 1977 – see also (Pinto, 1983).

In 1980 the Portuguese authorities adopted measures aiming at reducing inflation and accelerating economic activity. In order to reduce inflation, there was a 6 percent spot revaluation of the currency (after which the crawling-peg was maintained but at a lower rate). In addition, in order to expand aggregate demand, private investment was promoted and there were higher wage increases, which expanded disposable income and private consumption. However, these measures were taken against a background of international crisis, following the second oil shock of 1979. Therefore, the counter-cyclical expansionary stance of the Portuguese economic policy, together with the deterioration in the terms of trade, brought about a new deterioration of the current account. The current account crisis worsened in 1981–82 as the postponement of unpopular restrictive measures was accompanied by raising external indebtedness, and it became unsustainable when foreign credit stopped and authorities were unable to finance the increasing borrowing requirements. In this context, the Portuguese authorities were forced to call again for an economic stabilization agreement with the IMF. The second stabilization agreement with the IMF (1983–84) relied mostly on expenditure-reducing policies, so it was much harder than the first. This was perceived as necessary because the initial external and domestic conditions were less favourable and the external debt had grown in the meantime (from about 35 percent of GDP in 1979 to 90 percent in 1984). As a consequence, the real GDP growth rate was negative in 1984 and the unemployment rate rose substantially (by 2.5 p.p. between 1982 and 1985).

From 1974 until 1984 Portugal experienced a typical period of "stop-and-go", where the domestic savings (both private and public) were not sufficient to finance the investment needs associated with the catching-up process. As a result, a current account crisis emerged owing to the economy's financing needs. It is important to mention that the crisis broadly resulted from the high public sector financing needs, illustrating a typical

[1] The expenditure-reducing policies comprised increases in interest rates, limits on domestic credit growth, cuts in government spending and low (negative) real wage increases. The expenditure-switching policies consisted of currency devaluations.

FIGURE 4 Savings and Investment – General Government and Private Sector (inc. public firms)



Source: Banco de Portugal and INE

situation of "twin deficits". Nevertheless, the correction of the imbalances relied mostly on reductions in private domestic expenditure, which limited private investment and potential GDP growth (*Figure 4*).

3. Negotiating EEC Accession and Its Motivations

Portugal applied for EEC membership in March 1977. Negotiations for accession began in October 1978 and ended in June 1985 with the signature of the accession treaty. Nevertheless, the root of the Portuguese process of approach to the EEC can be traced further back in time with the signature of a preferential trade agreement in 1972. Apart from the normal complexity of the accession process, the reasons for the lengthy negotiation period lay on the serious macroeconomic imbalances that affected the Portuguese economy during these years, whose solution became a priority for policy-makers, and on the EEC's decision to make Portugal and Spain join simultaneously. In fact, Portugal unsuccessfully tried to decouple accession negotiations from those of Spain, whose larger economy made the negotiations more difficult, especially in the areas of agriculture and fisheries – see also (Royo, 2002).

The motivations for EEC accession were threefold – political, strategic and economic. On political grounds, the Portuguese accession to the EEC sought to strengthen the young democratic process. On strategic grounds, as a small peripheral country, Portugal must rely on broader markets to sustain economic growth and on multinational organizations to have some influence on international issues. In fact, the decolonisation process, which occurred after the 1974 revolution, eliminated most of the links with Africa and definitively turned European integration into a national long-term objective. On economic grounds, EEC membership implied a higher degree of openness, generating higher gains of trade (Figure 1). In addition, the European Structural Funds made it possible for the economy to maintain private and public investment at higher levels without incurring in unsustainable foreign account imbalances. Finally, EEC membership induced the adoption of micro and macroeconomic reforms that would otherwise have taken longer to occur. The accession process, as well as the subsequent steps in the process of economic and financial integration, benefited from a very strong national consensus, backed by the approval of the major political parties.

4. The Transitional Period and the Single Market

The transitional period that was negotiated for the Portuguese sectors to phase out internal trade barriers, to adopt the common EEC trade policy and to implement common technical, health and safety standards was set to last until the end of 1992.[2] Then, Portugal would fully integrate the starting European Single Market. Throughout the transitional period Portugal benefited from the European Structural Funds, aiming to modernize the economy through increases in physical and human capital. After accession in 1986, specific programmes for industrial and agricultural development (PEDIP and PEDAP) were launched. The reform of the European Structural Funds in 1988 integrated the existing specific programmes and made the whole territory of Portugal eligible for Objective 1 assistance, raising funds received from the EEC from 1.6 percent of GDP in 1988 to an average of 2.35 percent for the period 1989–93.

During the transitional period, Portugal implemented important structural reforms with far-reaching effects on economic growth. First, arising from the catalyst effect of EEC membership, there was a reform of taxation with the introduction of the VAT in 1986 and the introduction of new personal and corporate income taxes in 1989. The new taxes were more efficient, collecting higher revenues with lower marginal tax rates, thus reducing distortions. In addition, the new taxes reduced evasion and shortened tax payment lags.

Second, important structural reforms occurred in the financial system. These reforms comprised the authorization for private banks and new non-monetary financial institutions to operate and the gradual liberalization of capital flows with the EEC, which was fully accomplished by the end of 1992, when the European Single Market was initiated. In addition, in 1990 the new Organic Law of the Bank of Portugal was approved. This gave greater independence to the central bank in the formulation and implementation of the monetary policy and the principle that it could not grant credit to the public sector was accepted and gradually implemented until 1992.

[2] The exceptions were certain agricultural sub-sectors which, given their weaknesses, were supposed to adjust to the Agricultural Common Policy regulations by the end of 1995. However, as a counterpart to additional financial support, the adjustment process of these agricultural sub-sectors was later anticipated to last until the end of 1992.

Third, after the revision of the Constitution in 1989, Portugal embarked on a substantial privatisation programme, which continues until the present, although it almost stalled since 2000 due to adverse capital market conditions. Following the massive nationalizations in 1975, public ownership in the market sector in 1988 accounted for close to 19 percent of total value added, 6.5 percent of employment and 15 percent of total investment. The state-owned companies dominated some of the most important sectors such as banking, insurance, cement, transport, communications, energy and pulp, and were sheltered from competition. As a result, these companies were generally inefficient and ran losses.

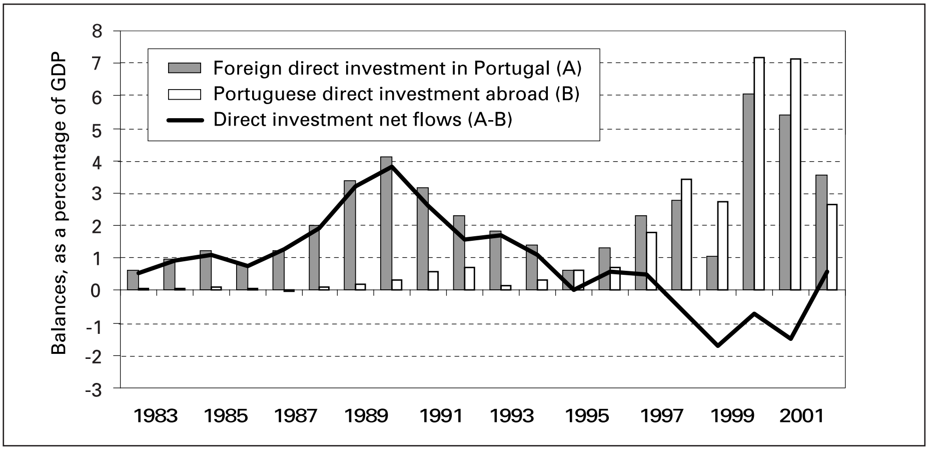
The Portuguese privatisation programme broadly comprised three phases. In the first phase the privatisation of state-owned banks and insurance companies represented the largest share of the programme. This was partly due to the specific point of departure, as these sectors had been massively affected by the nationalization process in 1975 and were almost entirely publicly owned.[3] Then, in the mid nineties, privatisations were centred on manufacturing sectors – cement, oil and pulp. Finally, in the late nineties, the privatisation programme centred on the large telecommunications and energy monopolies. The privatisation sequence, initiated in the banking and insurance sectors, enhanced the rapid liberalization of the financial sector in the first half of the nineties. Such modernization and the higher liquidity of the Portuguese capital markets facilitated the next privatisations. The privatisation of the large telecommunications and energy monopolies was left for the last stage because it required the establishment of regulatory authorities.

The gains of the privatisation process were visible both at the micro and macroeconomic levels. At the microeconomic level, privatisations increased competition and efficiency in the productive sector, leading to lower prices and higher output. At the macroeconomic level, privatisations represented a positive aggregate supply shock. In addition, according to the 1990 privatisation law, the proceeds from the sale of state-owned companies – which represented on average about 2 percent of GDP in the period from 1989 to 2001 – had to be used to redeem public debt or to make capital injections to other state-owned companies (see also Ministério das Finanças, 1995 and 1999). The breakdown of the proceeds to these ends was uneven throughout the process, taking the redemption of public debt an average share of about 49 percent in the period 1989–2001.

The use of privatisation proceeds to redeem public debt had a lasting effect on the general government deficit because it implied interest savings. The capital injections to state-owned companies were intended to facilitate the restructuring of those companies, some of them for future privatisation. However, they were often a means of reducing the compensatory payments due to public companies for their social activity, which would have otherwise increased the deficit. Therefore, both uses of privatisation proceeds led to reductions of public debt. Nevertheless, capital injections reduced the visibility of inefficiencies and the incentives to implement reforms in the state-

[3] At the beginning of 1989, around 80 percent of the financial sector was publicly owned, compared with about 15 percent in the manufacturing sector.

FIGURE 5 Direct Investment



Note: From 1996 onwards, direct investment flows include the item reinvested earnings and, therefore, are not exactly comparable with data from previous years.
Source: Banco de Portugal

-owned companies. In this sense, it would have been preferable to use all privatisation proceeds to the redemption of public debt.

Two additional structural phenomena occurred in the years following EEC membership, namely significant changes in the structure of international trade and higher FDI inflows. The degree of openness of the Portuguese economy increased, the share of intra-EU merchandise exports increased from about 75 percent in 1986 to about 80 percent in 1992 and the share of intra EU-merchandise imports increased from about 62 percent to about 77 percent in the same period. This phenomenon was particularly significant relatively to Spain whose weight in the overall Portuguese merchandise exports and imports increased from 1986 to 1992 by 8.2 and 5.7 p.p., respectively.[4] As for the trade pattern, the share of machinery and transport material in merchandise exports increased respectively by 8.7 and 10.1 p.p. from 1986 to 2000, while the share of clothing and footwear declined by 10.5 p.p. The change in the structure of merchandise exports was partly explained by the FDI inflows that followed EEC accession (*Figure 5*).

Such FDI inflows were due to comparatively lower wages in Portugal, expectations of high productivity gains and a higher credibility of the macroeconomic policy due to EEC membership. However, this process did not continue in the most recent years. The reduction of FDI inflows might be the result of rising relative unit labour costs and increased competition from Central and Eastern European countries. Simultaneously, the outward FDI flows have increased as some Portuguese companies have invested abroad in an effort to internationalise their activity and take advantage of better financing conditions.

Although very important, EEC membership was not the only positive

[4] The weight of Spain in the overall merchandise exports and imports increased from 1986 to 2001 by 13.6 and 17.2 p.p., respectively.

supply shock affecting the Portuguese economy in this period. As a matter of fact, the sharp decrease in oil prices that occurred in 1986 represented a gain in the terms of trade and implied substantial savings in oil imports (about 2.4 percent of GDP in 1986). In addition, the devaluation of the dollar and the decrease in the international interest rates had a positive impact in reducing the burden of external debt. In fact, the implicit interest rate on the Portuguese external debt decreased from 8.8 percent in 1985 to 7.4 percent in 1986 and the interest payments declined by 2.3 p.p. of GDP.

5. The Nominal Convergence Period: 1990–1997

In 1989, after some years of significant real GDP growth accompanied by decreasing inflation rates and moderate current account deficits, the inflation rate increased (Figure 2). This slippage in inflation was the result of several factors. First, the positive effects of the supply shocks that had occurred in the mid-eighties had ceased. Second, the buoyant behaviour of domestic demand overheated the economy. Consequently, the unemployment rate decreased and trade unions demanded higher wage updates. The inflation rate increase was mostly determined by the behaviour of prices on the nontradable sector. In fact, despite maintaining the crawling-peg regime, the monetary authorities did not accommodate the higher inflation differential, stabilizing prices on the tradable sector.

By 1990 the Portuguese economy was facing the challenge of accelerating the pace of nominal convergence with the EU as the project of the future EMU was being drafted. The participation in the group of countries that would found the EMU was clearly assumed as a national objective and the economic policy was managed accordingly. Aiming at reverting inflation into a downward trend, the Portuguese authorities took important steps. In October 1990 the crawling-peg regime was abandoned in favour of a regime where the escudo mimicked the behaviour of the basket of currencies taking part in the exchange rate mechanism of the European Monetary System (EMS) – an EMS shadowing regime – and the central bank broadly adopted a principle of nominal stability. This change in regime increased the credibility of the non-accommodating disinflation strategy with an important impact on the reduction of inflation expectations. In addition, the new stability regime would prepare the entry of the escudo to the exchange rate mechanism of the EMS, a requirement for accession to the EMU.

The adoption of the new exchange rate regime moved together with changes in the way the monetary authority conducted its operations. The monetary authority switched from direct to indirect control of interest rates, based on openmarket operations. In order to conduct the open market interventions in a more liquid market, new public bonds were issued and bought by banks. Such operations withdrew the excess liquidity lying in the banking system due to the existence of credit ceilings[5], which posed a threat

[5] The compulsory credit-ceiling regime was eliminated in March 1990 and replaced by guidelines regarding the growth of credit. The abolition of the credit guidelines occurred at the beginning of 1991.

to monetary policy. However, the change in the exchange rate regime maintained a monetary policy dilemma that was present after some time. In fact, the exchange rate's predictability and stability, together with domestic interest rates higher than those abroad, led to significant capital inflows, making it hard to manage domestic liquidity and endangering the disinflation efforts. In the same way, lower domestic interest rates would discourage short run capital inflows but would risk giving an expansionary stance to domestic demand. In order to solve this dilemma some barriers to international capital movements were temporarily reintroduced.

Another important component of the disinflation effort was based on changes in the wage bargaining process. From 1990 onwards, the authorities successfully detached wage updates from the previous year's inflation and centred instead on the next year's expected inflation. Simultaneously, by highlighting the inflation reductions, the authorities succeeded in lowering inflation expectations.

In April 1992 the escudo entered the exchange rate mechanism of the EMS, which was a proven inflation stability area (Kocenda – Papell, 1997). The entry into the EMS (to the 6 percent fluctuation band) fuelled a lively debate among Portuguese economists. On the one hand, such entry would clearly boost the credibility and the efficiency of the anti-inflationary policy and would represent a significant step in the process of economic integration. On the other hand, if the inflation in the nontradable sector remained resilient, additional real exchange rate appreciations would put the profit margins of exporters under serious pressure, so there would be the risk of a recession. The real exchange rate appreciation that actually occurred between 1989 and 1992 was relatively benign. In fact, part of the appreciation was the adjustment of the exchange rate to a new equilibrium, which is a phenomenon usually associated with a real convergence process (Balassa, 1964), (Abreu, 2001). In addition, the expansionary stance of fiscal policy in this period, while contributing to the real appreciation, sustained the growth of domestic demand.

In December 1992 the EMS was struck by a serious crisis, which led to the broadening of the currency bands to 15 percent. In this context and until the adoption of the euro, the escudo realigned its central parity three times (6.0 percent in November 1992, 6.5 percent in May 1993 and 3.5 percent in March 1995), partially accompanying the realignments of the Spanish peseta and not jeopardizing the nominal convergence process.

The nominal convergence criteria established in the Maastricht Treaty for accession to the monetary union were a vital benchmark for Portuguese policy-makers. By 1993, the exchange rate, inflation and interest rates were moving along a favourable path. The 1993 recession and the increase in unemployment facilitated further reductions in the inflation and interest rates. However, the public finance criteria represented a more demanding challenge. In 1993 the general government deficit stood at 6.1 percent of GDP, having increased 3.1 p.p. from 1992.[6] Such deterioration was due to

[6] General government figures published in the EMI Convergence Report of 1998. Taking the ESA95 criteria, the general government deficits amounted to 4.8 and 8.1 percent of GDP in 1992 and 1993, respectively.

the effect of the automatic stabilizers in a period of recession, the difficulty of the tax system to adapt to the Single Market regulations, which implied a temporary loss of revenue, and some discretionary measures (Cunha – Neves, 1995).

Throughout the years until 1997, upon whose data the decision of EMU accession would be based, the fulfilment of the public finance criteria became a priority. The reduction of the general government deficit strongly benefited from the substantial reduction in interest payments (from 7.2 p.p. of GDP in 1990 to 4.3 p.p. of GDP in 1997), mainly due to the lower implicit interest rates. In addition, moderate public wage updates and discretionary measures concerning the pension system allowed some containment of current primary expenditure growth. Finally, the improvement of the cyclical position of the economy also had a positive effect on the deficit. The continuation of this consolidation process after EMU accession, in a context of full convergence of interest rates and with no further significant savings on interest payments, would require continued public expenditure control, which did not occur.

6. Where Do We Stand Today? The EMU and the Challenges Ahead

The adoption of the euro as the national currency in 1999 represented a major success for Portugal. In fact, at the beginning of the nineties such an achievement would have raised serious doubts. The clear definition of objectives, which were widely shared by the economic agents, and the pursuit of consistent macroeconomic policies, were important factors of success. However, after 1997 important macroeconomic imbalances emerged in the Portuguese economy. Such imbalances consisted of high financing needs of the private sector, relatively high general government deficits and, consequently, high current plus capital account deficits (Figure 2). It is very useful to identify the underlying causes of this new macroeconomic situation.

The entry into a monetary union stands as a permanent structural shock to the economy, changing the stationary equilibrium levels of the macroeconomic aggregates, namely the current plus capital account deficits. There are two main channels through which relatively poorer countries may experience higher current plus capital account deficits during an economic and financial integration process. The first channel is through higher domestic total factor productivity and increased growth prospects, resulting from higher market competition and efficiency. In this case, there is higher investment, due to a higher marginal productivity of capital, and higher consumption, due to the anticipation of higher disposable income flows. The second channel works through financial market integration, which – coupled with the monetary union – reduces the cost of capital and eliminates currency risk. In this case, the decrease in interest rate lowers the cost of borrowing and eases liquidity constraints, leading to substantial lower savings, higher consumption and higher investment. The second channel seems to have been prevalent in Portugal in the second half of the nineties.

The decreasing interest rates and prospects of higher income led Portuguese households to increase consumption and investment, mostly in housing. The significant investment in housing was financed by domestic bank credit, which in turn recurred to external borrowing. The investment in housing contributed to a boom in the construction sector and to a rise in real estate prices (average growth rate of about 7 percent between 1998 and 2000). Such strong demand for new houses was the result of a clearly underdeveloped rental market[7], of households' preferences and of potential capital gains in a context of rising real estate prices and decreasing rates of return for other savings applications. Furthermore, the decreasing interest rates led to higher investment by Portuguese firms. The buoyant behaviour of private consumption and investment was accentuated by the pro-cyclical stance of fiscal policy, as measured by decreasing cyclically adjusted primary balances. In this context, the high growth rates of domestic demand, especially of its aggregates with higher import content, and the disappointing behaviour of the Portuguese exports of goods, which lost market share to emerging and Eastern European economies, led to a clear deterioration of the current plus capital account deficit, reaching a height of 8.9 percent of GDP in 2000.

From what was described above it comes clear that, contrary to the period 1974 to 1984, the recent foreign account imbalance was mostly the result of higher private sector financing needs (Figure 4).

Since the second half of 2000 the Portuguese economy is experiencing an adjustment process, which is expected to continue in the next years. The existing expectations about higher productivity growth and higher sustainable disposable income did not entirely materialize due to unsolved structural problems. In addition, despite the lowering interest rates, the strong increase in indebtedness increased the total burden of debt. As a result, private agents feel the need to readjust their balance sheets. The adjustment process of the Portuguese economy is visible in a lower contribution of private consumption and investment to GDP growth. In the same way, after reaching a general government deficit of 4.2 percent of GDP in 2001, clearly above the 3 percent reference value established by the Stability and Growth Pact, the fiscal policy must definitively turn to a tightening stance. Therefore, at present, the economy is witnessing a lower contribution of domestic demand to economic growth, which has not been totally compensated by an increase in net external demand. As a result of the adjustment process (and also the normal effects of the world economy on the Portuguese business cycle), the GDP growth rates are low, the savings rate has been increasing – mostly associated with the financing of debt interest and repayments – and the current plus capital account deficit has been decreasing from the very high levels attained in 1999–2000 (Figure 2).

Although in a quite different context, the booming years after EMU accession and the present adjustment process, characterized by a period of protracted low growth with low investment, somewhat resemble a "stop-and-

[7] Affected by rent freezes though large periods of the twentieth century. Only in 1985 did new leases start to reflect market rents.

TABLE 1 Supply Side Indicators

	1961–73	1974–85	1986–90	1991–95	1996–2002
Growth of net capital stock (real)	2.7	4.7	3.7	3.4	4.1
Net capital/output ratio (real)	2.3	2.1	2.2	2.3	2.4
Growth of capital intensity	2.4	5.1	2.6	4.0	2.5
Labour productivity growth	6.6	2.6	4.6	2.3	1.5
Total factor productivity growth	5.8	1.0	3.7	1.0	0.7
Memo: EU-15 total factor productivity growth	3.0	1.0	1.5	1.1	0.8

Source: AMECO

-go" situation like the ones Portugal has experienced in the past. The participation in the EMU rules out the occurrence of a currency crisis. However, the existing low factor productivity hampers the ability of the economy to finance domestic demand without running important current plus capital account imbalances.

The Portuguese productivity level converged to the EU average at a relatively slow pace, meaning that economic growth has mostly benefited from higher factor endowments, namely a higher capital stock and a higher labour market participation rate (*Table 1*).

The full explanation for the insufficient productivity growth is not easy to obtain and the required policies in this area take time to produce results. Low labour force average qualification, small average size and lack of entre-preneurship of firms and regulatory induced distortions are amongst the most cited problems. Therefore, the policy responses must focus on fast-er and generalized human capital accumulation, higher investment in machinery and equipment, which embodies new technologies, competitive tax structures and improved management methods and attitudes – see also (Fortin, 2002). The efficient utilization of the European Structural Funds is also a much-debated issue, especially in the case of comparatively poorer countries like Portugal. In this respect Portugal registered success in improving its infrastructure but as far as professional training and industrial modernization are concerned the results are questionable.

7. Final Remarks

The path of the Portuguese economy towards monetary and economic integration has been relatively successful. This is visible through the real and nominal convergence to the EU average. Nevertheless, there are lessons to be drawn and important challenges lie ahead. The main lessons are that trade liberalization and market competition, as existing in the EU, are important drivers in real convergence and the existence of clear and politically assumed macroeconomic objectives facilitates nominal convergence. Furthermore, nominal convergence does not ensure by itself a sustained output growth. As the standard economic theory underlines, sustained output growth must rely on supply-side policies that increase total factor productivity, to be implemented preferably in periods of economic expansion in order to mitigate the adjustment costs. Therefore, the challenge for the Portuguese economy is to accelerate such liberalization and productivity-promoting supply-side policies, while avoiding an excessive growth of domestic demand. This will make the economy fitter to accommodate to adverse internal or external shocks. Otherwise, macroeconomic imbalances will eventually re-emerge and a period of protracted low growth will then be required to correct them.

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SUMMARY

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The Path towards Economic and Monetary Integration: The Portuguese Experience

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The Portuguese economy initiated its path towards economic and monetary integration in 1960 by taking part in the group of countries that founded the European Free Trade Association. Since then until the adoption of the euro as the national currency in 1999 a long path was followed. The economic and financial integration process has been successful and benefited from the support of a large majority of domestic agents. Along this path the country witnessed substantial real and nominal convergence to the European Union average. However, Portugal is still lagging behind and important challenges lie ahead. Economic and financial integration in the EU was a catalyst for needed economic reforms, it increased the degree of openness and the gains from trade and facilitated nominal convergence through clearly defined and politically assumed macroeconomic objectives. Nevertheless, as the recent years in Portugal illustrate, financial and monetary integration do not guarantee sustainable economic growth nor avoid macroeconomic imbalances. Only continued increases in total factor productivity based on effective supply-side policies can deliver these results.