

## Lessons from Portugal's Long Transition to Economic and Monetary Union

### Francisco Torres

#### Introduction<sup>1</sup>

As in most other EU countries, perhaps even more so in the case of Portugal, the challenge of Economic and Monetary Union (EMU) has worked as a mechanism for economic stabilisation and as a pre-condition for structural reform and long-term development. It has created the necessary consensus to overcome specific interests in the pursuit of social and economic welfare. The political consensus took however long to build – much longer than in countries such as Ireland or Spain – and it faced a loud opposition – a time-lagged mimic of France's – but seems to be mature with respect to EMU and, again very slowly and clearly behind most EU countries and some candidate countries, also developing with respect to other goals of European integration, such as environment quality, consumer protection, internal social cohesion, all pre-conditions for long-term development.

In spite of being many times referred to as a success in terms of European integration, namely with regard to EMU, the political merits of the Portuguese experience are, in my view, in general over-estimated. In fact, until 1992, the ambiguous Portuguese response to the need for institutional reform and European integration was mirrored by complete discretion regarding the future course of exchange rate policy and the timing of monetary reform.

It was only with the Country's first presidency of the European Council in 1992 that Portugal's attitude towards European monetary integration changed and the escudo joined the ERM. It proved decisive however that not only ERM membership but also full convertibility of the escudo had taken place (or at least had been decided upon, in the case of the dismantling of controls) and to have had a clear economic and political strategy for achieving macroeconomic convergence before the European recession of 1992/93 and the outbreak of the ERM crisis. The maintenance of the course of policy (compatible with the objective of EMU participation) throughout the heights of the European recession in Portugal (1993/94), the electoral year of 1995 and the two first years of a new legislature (1996/97) with a minority Government with a different political colour was only possible thanks to that very political decision.<sup>2</sup>

In the next section I present what I considered<sup>3</sup> the benchmark argument for Portugal to join a monetary union that was based on institutions delivering price stability – a means to implement a solid strategy of sustained economic development – and I discuss how it was perceived by policy makers and the public. The third section focuses on the politics of macroeconomic stabilisation. In the fourth section I look at the change of regime (to exchange rate convertibility and ERM participation) and political consensus building, regarding EMU and a new policy stance on European integration. The fifth section considers the evolution of political and policy misgivings on EMU.<sup>4</sup> The sixth section analysis trade integration and the similarity of economic structures between Portugal and *Euroland*. In the seventh section I look at different institutional features of the Portuguese economy, focusing especially on the flexibility of the Portuguese labour market and the unemployment problem in a comparative perspective but also discussing the change in the monetary authorities' institutional role and competition policy. The eighth section gives an overview of other developments of the Portuguese economy such as: the slow change of attitude towards structural funds, pre-euro exchange rates and compliance with the convergence programme and the stability pact.

#### Understanding the argument of adopting a credible monetary constitution

Joining a monetary union that is based on institutions that deliver price stability is, as stressed by the modern political economy literature, probably the best way to implement a solid strategy of sustained economic development. The reason is that this option also precludes many of the transition costs (the output losses of a disinflation strategy) of such a regime change. Fixed exchange rates, unlike other policy targets, are easily observable by the private sector but also easily implemented by the authorities.<sup>5</sup>

With a single currency, the authorities raise the political costs of inflation because their anti-inflation commitment is constantly monitored by the private sector and any different behaviour would imply a loss of competitiveness for the tradables sector. Accordingly, one could argue that, as a tendency, high inflation countries tend to gain more than low inflation countries by sharing their monetary autonomy in a common monetary institution. Eliminating inflation in this way, abolishing different currencies, does away with the need to waste resources on hedging against exchange risks. A common monetary institution that delivers price stability is therefore a welfare improving mechanism in a double sense.<sup>6</sup>

Later on that argument was contested by “Keynesian” economists and eurosceptics in general. That loud opposition did not affect the course of action (the convergence programme) towards EMU but it did divert the attention of the political and economic debate from other important reforms geared towards sustainable development, where Portugal is clearly lagging behind the European average, to the merely rhetoric issue of real versus nominal convergence.<sup>7</sup> This “Keynesian” view claimed that the exchange rate was still a very important adjustment mechanism not only in the case of unexpected asymmetric shocks but also in the face of foreseen developments such as world trade liberalisation and EU enlargement to Central European countries. It was argued that regions characterised by persistent differences in productivity growth or even by any other type of persistent differences as well as different structural characteristics of the economy (non-wage labour costs, savings ratios, or demographic structures) should not form a monetary union.<sup>8</sup>

Although these are problems unrelated to the exchange rate regime, the “economic” discussion around EMU in Portugal centred around these very issues.<sup>9</sup> After the European recession of 1992/93, real versus nominal convergence became the most popular line of discussion not only amongst economists but also amongst politicians and political and economic commentators. Many of those politicians and commentators found it also politically interesting to oppose what they called grey technocracy and/or monetary fundamentalism.

The root of one of the main misunderstandings about the entire process of monetary unification in Portugal and some other EU countries was, in fact, that many people tended to see it as a technocratic obsession and/or an ideological defence of the market. At the same time some of the forceful opponents of EMU happened to be technocrats (sometimes diplomats, central bank employees and even eurocrats) and/or ideological free-marketers (as for example conservative economic advisers and independent economists in the UK or the group of 155 economists in Germany that signed a manifesto asking for a delay of the entire EMU).

In my view, adopting a credible monetary constitution is a means of doing away with the primacy of monetary policy over more important concerns facing society. For countries, such as Greece, Portugal, Spain and even Italy (and now all the applicant countries), with less developed fiscal and monetary institutions, EMU was a means of getting rid of national currencies and all the economic jargon that goes with them, typically the excuses technocrats find to cling to power and implement all kinds of mercantilist policies in the name of short-term real convergence. In the case of Portugal, these very policies, that have been pursued until now<sup>10</sup>, implied a sharp deterioration of social cohesion and quality of life, undermining the long-term (sustainable) real convergence with the most developed regions of Europe.

During the entire convergence period, few people presented EMU as a desirable political reform instead of an external constraint. For a long time, most politicians, bureaucrats and even economists, just referred to it, first, as an objective rather unlikely to take place and, later on, as an unavoidable development of the European Union.<sup>11</sup> Presented in this way, EMU could have been (and in fact it was at different periods) easily blamed for all the policy errors made by national governments, monetary authorities and other national or European institutions.<sup>12</sup> The decisive argument was that, in a multi-speed EMU, it would have been more difficult for the catching-up countries to converge, in the sense that by being left out of EMU's third phase they risked becoming more vulnerable in the international financial markets. There was also the perception that the core members would have been reluctant to enlarge the club (formed by *euroland* founding members) both in the monetary sphere and in other domains of European integration.

### **The politics of macroeconomic stabilisation**

In the beginning of the 1980s, while Europe was stagnating, Portugal grew at an average annual rate of 3 per cent but the terms of trade deteriorated at an equivalent pace. In 1983-95, an adjustment programme with the International Monetary Fund (IMF), negotiated by an emergency cabinet, a PS-led coalition with PSD known as “bloco central”, restored the external balance. Negotiations with the European Community concerning the accession of Portugal were also completed during the same period. By 1985, inflation was reduced by ten percentage points and the current account was again in surplus. Public sector imbalances were however not tackled: the public debt kept rising until 1988 (to a peak of almost three quarters of GDP).

After the IMF adjustment programme, new elections and entry to the EC, the successive governments of the PSD pursued a strategy of gradual convergence toward Community standards. Formally the strategy comprised a sequence of adjustment programmes. The character of each of these programmes and the extent to which they were implemented (from 1985 to 1995) reflected the evolution of factors such as a

new amendment to the Constitution, external economic conditions, integration with the European Community, the model of integration adopted by the government and the electoral cycle.

The first two adjustment programmes featured fiscal adjustment and privatisation of state-owned enterprises to stabilise the ratio of public debt to GDP. The programmes were aimed at redressing major macroeconomic imbalances but did not modify the exchange rate regime, officially still a crawling peg.

In 1986 and 1987, the Portuguese economy was characterised by relatively high economic growth and substantial progress in reducing inflation (from 19.3 per cent in 1985 to 9.4 per cent in 1987) which was mainly due to the decline of both the dollar and the price of oil and to world economic growth. Joining the European Community at the end of the period of Euro-sclerosis and the beginning of the EC-1992 Single Market programme meant that optimism was also an important factor in promoting economic growth and moderating inflation. Due to its increased openness, the Portuguese economy benefited substantially from that effect. Between 1985 and 1988, Portugal's terms of trade improved by almost 6 per cent a year. This in turn made it possible to pursue an expansionist policy without any major adverse impact on inflation, despite the introduction of both the Value Added Tax (VAT) and an extra tax on oil products in 1986. At the same time, domestic fiscal transparency, meaning both greater fiscal discipline and especially a more open reporting of fiscal decisions, was significantly increased and curbing inflation with specific annual targets became a clearly stated policy objective. Reform of direct taxation also took place in 1989 raising total revenue as a percentage of GDP.

However, by 1988 the anti-inflation effort came to a stand-still. This was partly due to the combination of full employment with high economic growth, a clearer perception by the private sector of the inflationary effects of a high public debt and to the lack of a clear-cut strategy for disinflation in the face of slowing global growth. The de-emphasis on fighting inflation was underscored by a stated shift in policy objectives: from the priority of fighting inflation to the need not to slow down the catching-up process with the rest of the EC. Less control of domestic capital markets, large capital inflows, a postponed transition to a system of indirect credit control that reflected the fears of the monetary authorities to liberalise, coupled with the lack of a clear strategy for the exchange rate policy and the slowdown of the pace of fiscal adjustment further weakened the anti-inflation credibility of the authorities.

In 1985 the crawling peg regime, coupled with capital controls, credit ceilings and administratively set interest rates had allowed the government to collect implicit revenues from the productive sector. The crawling peg was no longer effective in altering relative prices or compensating for inflation differentials with Portugal's main trading partners.<sup>13</sup> At a time of greater financial openness and closer monetary integration, this exchange rate limbo was incompatible with a strong commitment to fiscal adjustment. The inflation rate turned out to be almost 8 per cent above the initial (successively revised) target.

Throughout the 1980s, the Portuguese government sided with Mrs Thatcher's government in its sceptical attitude towards rapid institutional reform, namely monetary reform, in the European Community. The Minister of Finance, a prominent anti-EMU voice, felt very uneasy about swift European monetary integration because of its perceived potential costs in terms of economic and social cohesion and loss of national sovereignty.<sup>14</sup> In fact, he was never an enthusiast of central bank independence and shared the initial sceptical view of the Government on rapid European monetary reform. Conversely, the monetary authorities, unlike their European counterparts, initially favoured an exchange rate rule based on external competitiveness (the crawling peg) and later on a national (protectionist) solution for increased central bank independence (power), i.e. capital controls rather than EMS discipline.<sup>15</sup>

A new adjustment programme dubbed QUANTUM, for "the Transition to Economic and Monetary Union", was approved in June 1990. At the beginning of 1990, a new Minister of Finance, formerly a central bank board member, re-established disinflation as a priority. Soon it became clear, however, that he would follow the Central Bank, postponing the liberalisation of capital controls and EMS entry. Besides, a sweeping adjustment of the public sector wage scale increased substantially the wage bill and had demonstration effects in the private sector. The coincidence with the elections that took place in October 1991 made it appear as part of the political business cycle. As a result, fiscal adjustment did not materialise in the 1990-91 period. On the other hand, capital controls, credit ceilings and administratively set interest rates gave the monetary authorities the illusion that monetary autonomy could last forever. This illusion meant the adoption of a policy of capital controls (on inflows) pursued between 1990 and 1992 which resulted in artificially high interest rates. These in turn were responsible for a higher debt service of the treasury, significant losses by the central bank and substantial distortions in economic performance. Moreover these high interest rates implied an unwarranted transfer of resources from the productive sector to the sheltered financial sector.

## **The change of regime and the political consensus building**

### *Joining the ERM and abolishing capital controls*

The new government that came out of the general elections of 1991 announced full participation in Economic and Monetary Union as a clear policy objective. The new adjustment programme<sup>16</sup>, designed for the period 1992-95, marked a clear change in regime: from discretion to rules and from capital controls to free capital mobility. This change in regime however was never announced (and perhaps never understood) as such.

Only with the country's first presidency of the European Council during the first half of 1992 did the Portuguese government's attitude towards the European integration process change and the escudo joined the ERM: the initial sceptical view was abandoned and from siding with the United Kingdom Portugal turned towards the Franco-German axis. The escudo joined the ERM on 6 April 1992 as part of the convergence programme and during (and probably also thanks to) the Portuguese presidency of the European Council. A few months later the turmoil in the European exchange rate markets began and the momentum for EMU was lost amidst the recession. In any case, 1992 was a landmark in terms of fiscal consolidation, with results already complying with the Maastricht criteria: the deficit and the public debt to GDP ratios amounted to 2.9 per cent and 59.2 per cent, respectively.

The European recession of 1992/93 and the ensuing credit conditions from capital controls angered the social partners. Paradoxically, the opposition to EMU blamed participation in the ERM cum the liberalisation of capital controls, and what was called the obstinacy of the Government over nominal convergence, for the recession.

The political consensus needed to pursue the reforms was nearly broken, since the blame for high interest rates was placed on exchange rate policy (as a result there were constant calls for a devaluation of the escudo that grew with recession in the Portuguese traditional export markets, and in particular in sectors such as textiles and clothing) and on the convergence programme (responsible, according to that view, for the lower rate of growth of the economy).<sup>17</sup> As in other liberalisation experiments, anti-reform interests (in that period, the banking system sheltered from external competition but also, to a lesser extent, the traditional export sectors) tried to blame liberalisation for the international recession that was affecting the economy in order to resort to protectionism, allowing for specific returns (higher interest rates in the case of the banking system) and/or enhancing their political power (within the Government and the Central Bank).<sup>18</sup>

It proved decisive, however, that full convertibility and ERM membership of the escudo had taken place or had been decided upon, in the case of dismantling controls, before the European recession and the exchange rate crisis. The period of exchange rate turbulence in the EMS, in spite of its negative effects, provided clear relief to the Portuguese economy. In fact, a monetary policy of capital controls designed to keep domestic interest rates stable at very high levels was substituted for a monetary policy of capital mobility and exchange rate stability (the escudo in the ERM) designed to keep domestic interest rates at (much lower) international levels although more volatile (in the very short-term) in the wake of speculative attacks against the escudo. During the same period, inflation came down from 9.8 per cent in May 1992 to 5.6 per cent in June 1993 and interest payments on the stock of outstanding debt, while rising in most EU countries, fell significantly in Portugal.<sup>19</sup> During the crisis, Portugal was also the only case in the EU whose foreign debt classification was upgraded.

The early 1990s proved also to be a most valuable learning period for policy-makers, social partners and economic agents in general.<sup>20</sup> It was possible for the private sector to learn more about the policy rule and eventually understand it, while the various realignments were seen as a true escape clause beyond government control (to be triggered only in the case of asymmetric shocks). Those circumstances granted some breathing space to the real sector of the Portuguese economy while accomplishing the change in regime.<sup>21</sup> It was the first time for many years (since 1891, when the Portuguese currency left the Gold Standard, with the exception of a period of less than three months in 1931, when it returned to gold convertibility) that Portugal was living in a regime of full convertibility of its currency.<sup>22</sup> While it had been impossible to pursue structural reforms without the liberalisation of the economy, it proved decisive to have had a clear economic and political strategy for achieving macroeconomic convergence before the European recession of 1992/93 and especially before the outbreak of the ERM crisis. The escudo managed to survive the deepest post-war recession in Europe without leaving the ERM and without resorting to capital controls at any time.

### *Enduring the objective of EMU and building a cross-party consensus*

While the expenditure of the state sector remained on target in 1992 and 1993, tax revenue fell much

below its predicted value and social security expenditure exceeded its target in 1993, inducing a slippage in the process of fiscal consolidation. This interruption was mainly due to the recession (negative growth generated a lower total revenue that fell from 34.1 to 31.7 per cent of GDP and increased unemployment, inducing higher social security transfers) and to the virtual collapse of tax administration. Despite this discontinuity the Portuguese public debt ratio as a percentage of the average EU debt ratio kept falling from 1993 through 1997. In any event, the scale of the revenue slippage was totally unexpected and provoked a general sentiment of failure. The opposition to the strategy of macroeconomic convergence for participation in EMU and the debate on the costs and benefits of EMU became centred then on the issue of real divergence. Attitudes towards a European currency have then changed with external economic conditions. Until 1996, there was a loud ideological opposition to EMU (and European integration) in spite of a clear political (parliamentary) majority in favour. Most of this opposition disappeared when it became clear that Portugal would be able to join EMU from the very start.

Maintaining the objective of EMU participation during the recession of 1993/94 and throughout the electoral year of 1995 was only possible because of the steps taken before, i.e. joining the ERM and liberalising all administrative controls on capital flows. As the elections approached, the opposition Socialist Party converged on the same objectives concerning Portugal's participation in EMU. And, as political colours changed, the new Socialist-led minority government adopted the convergence programme of the previous executive, initially with some "national reservations" in order to ensure support both from the right-wing anti-Maastricht party, the CDS-PP, the left-wing communist party, PCP, and its own party basis and later on, by May 1996, as a government commitment with the main opposition party, the PSD. In October 1996 it became evident that both the Government and the PSD were in support of satisfying as quickly as possible the macroeconomic convergence criteria in order to participate from the beginning in EMU.<sup>23</sup>

The 1997 and 1998 budgets aimed at satisfying all the necessary requirements established in Maastricht. They were approved in Parliament with the abstention of the PSD, since the two anti-EMU parties had indicated early on that they would vote against a budget geared to Portugal's participation in EMU. In February 1997, the PS and the PSD also approved a parliamentary resolution in favour of Portugal participating from the start in the Third Phase of EMU. The PSD had no other alternative, given the fact that its government had taken the escudo into the ERM in 1992 and that, in spite of its customary lack of enthusiasm for EMU and European integration, it was unprepared for anticipated elections. Yet, the first time such a position was defended in 1996, by the author as parliamentary spokesman for European Affairs in the PSD, it was strongly contested by its leadership. As it was clear that no matter what the position of the party the author would stick to the electoral programme he had stood for, as economic spokesman during the campaign, and that the electorate would not understand any opportunistic behaviour concerning such an important external objective, the PSD abided by the European consensus.<sup>24</sup>

### **Smoothing out political and policy misgivings on EMU**

The discussion about Portugal's participation in EMU evolved significantly since the objective was put forward in the Delors plan. Initially, the idea of a monetary union in Europe was well received by the public in general as a long-term European goal, although there was some scepticism as to Portugal's capacity to participate. The Portuguese economy was presented to the public, by the Government, opposition and social partners, as a peripheral country that was still catching up making a long transition period for monetary and financial liberalisation necessary while concentrating on how to cope with the more immediate challenge of the Internal Market. Portuguese public opinion and polity became used to what was until then the norm, namely that Portugal would be granted yet another transitional period.

Against this background of relative indifference and the stubbornness of the monetary authorities in not discussing the matter, the Parliament was, as in other instances of the process of European integration (such as the issues of the revision of the Maastricht treaty, of the accountability of the European Central Bank and of the so-called reinforced cooperation), at the forefront of the discussion: in 1990 it organised an open debate on Portugal, the EMS and EMU that prompted political debate and forced the authorities to take a position on the matter<sup>25</sup>, although political commitment to EMU was not on the agenda until 1992. Contrary to most other EU countries<sup>26</sup> the Portuguese Central Bank was never an enthusiast of ERM participation, free capital movements or European monetary integration; but when reforms were accomplished or decisions taken, sometimes against its preferences, it followed the new rules.

With the European discussion about the ratification of the TEU, one renewed political party, the CDS-PP, adopted as its main political strategy an anti-Maastricht (anti-EMU) campaign. The exchange rate crisis

cum the European recession together with the adoption of a convergence programme designed to allow Portugal to participate in EMU brought the issue to the forefront of the public debate.

Of course, economists at the Central Bank and at the Ministry of Finance and academics with international experience, but also the two main political parties and a small part of the business community, defended that, given the macroeconomic disequilibria in Portugal at the time, the convergence criteria and the stability pact were important and instrumental, independently of the TEU, to achieve sustained economic growth.

But part of the business community, such as the Confederation of Industry (CIP) and the Portuguese banking association<sup>27</sup>, the right wing PP, the technocrat (Keynesian) and the conservative and populist wings of the PSD, on the one hand, and the left wing trade union, CGTP, the left wing PCP, the economic adviser to the President and many independents close to the PS and/or influential in the media, on the other hand, depicted the convergence criteria as a problem for real convergence. This argument was often mixed-up with ideological reasons.

Even the sectors politically more favourable to Portugal's participation in EMU, such as the centre-left trade union, UGT, and the Portuguese industry association (AIP) cautioned against the negative effects of EMU on unemployment and growth. But, besides the afore-mentioned arguments of persistent differences in productivity, EU enlargement and world trade liberalisation, no explanations were put forward to justify these presumptions. It seemed, however, that although people both could not explain why and how EMU would be a problem for Portugal, and understood that exchange rate autonomy would not serve to resolve the structural problems that affected Portugal and Europe (on the contrary, it could only aggravate them), there was until 1998, when Portugal qualified for EMU, a generalised concern that Portugal was not up to the job, that somehow things would go wrong.

This mood improved with economic conditions although many went on not believing that the Portuguese economy could ever compete at any level within the Internal Market, especially with the forthcoming enlargement of the EU to Central European countries and the liberalisation of world trade. The pessimist, and sceptic in general, warned against the social and political unrest that would spread, from countries such as France, to the whole of Europe.<sup>28</sup> In any case, apart from other "ideological" reservations, real versus nominal convergence remained the issue in the Portuguese public debate about EMU.<sup>29</sup>

At the same time, however (note the contradiction), most social partners (with the exception of CGTP), political economists (with the exception of some economic commentators, anti-EMU for ideological reasons<sup>30</sup>) and public opinion at large also cautioned against the possibility of Portugal being left out of EMU and of the weakening of its position in the EU as a whole. They realised that there was no alternative to EMU and that it was better to be part of it than to be "out in the cold". This was in fact the reasoning the Government used to overcome "ideological" or "Keynesian" reservations to EMU, also within its own political basis. This has been a constant feature of the politics of European integration in Portugal. Negotiators (the monetary authorities and the administration in general, including cabinet members with a lower political profile) supported by reactive political parties, resist to any substantial institutional changes, to any increased sharing of national sovereignty, until the important decisions are taken at the top political level. The fear of being left out of the European integration process or, more recently, of being out of its political core is sufficient to trigger the change in attitude. Negotiators and reactive politicians adapt then quickly to the new rules. That was the case of EMS membership and of all the intergovernmental conferences (including the current one).

The issue of reinforced cooperation is a good example: it was initially strongly rejected by Portuguese negotiators but, after discussions at the highest political level – heads of state and government -, it was first accepted during the 1996 IGC, and later even endorsed and presented as the Portuguese presidency's contribution to the 1999 IGC. The speech delivered at the Humboldt University in Berlin by the Minister of Foreign Affairs of Germany, Joschka Fischer, during the Portuguese presidency was received with scepticism and even misgiving. The prompt welcome of that speech by the Portuguese Minister of Foreign Affairs, Jaime Gama, has however circumscribed open criticism only to the opposition political parties, silencing the voicing of the customary discomfort (resistance to change) within the Administration at large.

*Joining EMU in the first tier* As in other domains of European integration, Portugal would accept that if unable to participate from the start in EMU others could go ahead.<sup>31</sup> It was feared, however, that, in practice, the first group of countries to take part in the Executive Board of the European Central Bank would move forward in all other domains of political cooperation, leaving the others effectively out of the political core. On the other hand, it was also feared that convergence would be more difficult for outsiders.

That is why both the Government and the main opposition party started to defend by the end of 1996, after many quarrels about the subject, that Portugal should participate in EMU irrespective of any automatic transfers and of what would happen to other Southern countries, including neighbouring Spain.

In fact, if Portugal was to participate from the start in EMU while Spain was not, there should not have been any significant costs even in the short run. Unlike Ireland or Britain,<sup>32</sup> Portugal was much less dependent on its bigger neighbour: Germany was (and still is) the biggest customer of Portuguese exports (in 1996 even France ranked above Spain), although Spain has become the biggest supplier of Portuguese imports and competed directly with Portugal in third markets. Besides, Spanish attitudes towards EMU were rather different from the UK's (especially before 1997): if Spain was not to participate from the outset in EMU, it would most likely have pursued a policy of exchange rate stability in order to join one or two years later (as Greece is preparing to do in January 2001).

Still, some (as the former Prime Minister Aníbal Cavaco Silva) argued that, politically, it would have proved very difficult to separate the two countries in the event that Portugal had performed only marginally better in terms of the convergence criteria. But, one could have argued<sup>33</sup> that if EMU was to go ahead with the core group of countries, Ireland, Finland and Portugal – all with bigger neighbours that could either hesitate from participating in EMU or fall short of fulfilling the convergence criteria – it would provide a case in point for the fact that variable geometry was not an alibi for a European geographical divide.

#### *What kind of institutional reform?*

In Portugal there has been a consensus among the major political forces<sup>34</sup> and trade and business groups about the goals of active participation in the process of European integration and increased economic and social cohesion. This consensus translates into an active employment and social policy and into participation in the major institutional reforms of the European Community, as a means of securing political and macroeconomic stability while preserving Portugal's most self-praised "universal vocation".

The objectives of reducing inflation and improving the efficiency of labour, product and financial markets featured prominently in the adjustment effort, in line with the understanding that the most useful structural policy measures were those which reinforced the role of market mechanisms in resource allocation. While this understanding was stressed in several Government documents before and after 1995 – namely in the Portuguese contribution to the White paper on Growth, Competitiveness and Employment<sup>35</sup> and in the Strategic Options of the Government for 1997<sup>36</sup> – the political debate neglected it until just before Portugal entered EMU.

#### *Calls for automatic transfers*

Until 1996 there were constant calls from party circles and from within the Government for automatic EU transfers (a safety net for EMU). When it became clear, by the end of 1996, that it would be possible to fulfil the convergence criteria and that such claims would affect the very credibility of the Government's commitment to EMU, the idea was suddenly abandoned.<sup>37</sup> Those claims would have only aggravated displeasure of the net-contributor countries with cohesion and structural funds and would have implied the shifting of resources away from cohesion countries with relatively low unemployment, such as Portugal, to countries with high unemployment, such as Spain. When the Portuguese authorities fully understood that possibility they adopted the idea of "employability" for the negotiations of Agenda 2000.

Since fiscal integration raises issues of re-distribution, automatic fiscal transfers would have been inappropriate without an important leap forward in the process of European political integration. After German and Dutch calls, during an ECOFIN meeting (in September 1997), for an elimination of the cohesion funds for countries participating in EMU, the Portuguese Government adopted (finally) a clear policy stance towards funds and employment, de-linking EU transfers and the principle of social and economic cohesion, enshrined in the TEU, from any other type of transitory transfers directed at smoothing the functioning of EMU.

#### **Trade integration and similarity of economic structures**

From an economic viewpoint, the high degree of Portuguese trade integration with the EU always pointed to high benefits and low costs of participation in EMU. Portugal's trade integration with the European Union had been well above the EU average (80 per cent of total exports and 75 per cent of total imports in 1995 and in 1997). In 1997, with respect to Portuguese imports, Spain had remained (since 1991) the most important supplier (with a share of about 30 per cent of total imports from the EU), followed by Germany (21 per cent). France was Portugal's third most important supplier (with a share of about 15 per cent of total imports from the EU). The situation was the opposite for the most important Portuguese export markets: Germany led (with a share of about 27 per cent of Portuguese exports to the EU) and France and

Spain followed (with a share of about 18 per cent). These three trading partners were followed by the Benelux countries, Italy and the UK. The situation has not changed.

With respect to the likelihood of asymmetric shocks affecting the future European monetary union, it is important to know how similar the trade and industrial structures of Portugal and the EU were. According to data available at the time of the pre-entry debate<sup>38</sup> on the correlation between average intra-EU exports, and exports of each EU-member state to other EU members, the trade structures of Ireland, Denmark and Portugal deviated moderately, but not as much as the trade structures of Finland and Greece, from the EU average.

In fact, EC membership, and hence better access to the internal market in 1986, triggered an initial rapid expansion of the traditional Portuguese manufacturing sectors (textiles, clothing and footwear production) and brought about an increased specialisation of the economy. But increased world-wide competition, fragmentation, poor marketing and higher domestic interest rates (due to the policy of capital controls pursued in 1990 and 1991), on the one hand, and the modernisation of the economy and foreign direct investment (FDI) inflows, on the other, have since then modified that trend towards more similar economic structures.<sup>39</sup>

Notably, exports from the *Auto Europa* joint venture, a FDI between Ford and Volkswagen with investment outlays equal to 2.9 per cent of GDP, that began production of multi-purpose mini-vans at its new car plant in Palmela (greater Lisbon area) by mid-1995, are estimated to have reached almost 10 per cent of total merchandise exports in 1996 and 1997. This investment compensated for the fall in employment in the textile, clothing and footwear producing sectors (mostly based in the north of the country), which experienced job reductions that accounted for almost the entire employment reduction in 1995.

In addition, besides precarious agricultural and traditional specialisation in manufacturing sectors such as textile and clothing, the Portuguese industrial structure has been highly fragmented (firms with fewer than 500 employees account for almost 80 per cent of total employment). Such a structure is good for competition (and for the flexibility of the economy), but bad from a resource allocation point of view. For instance, in 1992 half of industrial R&D was still concentrated in 5 large firms in the electronics, telecommunications and paper sectors,<sup>40</sup> and more than half geographically concentrated in Lisbon and the Tagus Valley. This concentration of domestic resources may have prevented a faster real convergence with the EU.<sup>41</sup> On the other hand, most of foreign direct investment made between 1989 and 1992 – after liberalisation and before the Central and Eastern European economies were opened up – went to the tertiary sector (banking, insurance and business services) which experienced a substantial increase in productivity. In short, the structure of the Portuguese economy still deviates from the EU average.

Although the specialisation pattern became initially more pronounced, it seems that the structure of the Portuguese economy has become more similar to the European average since 1994/95, not in the last place because of foreign direct investment. Still, differences in the industrial structure will persist (changes in the industrial structure take time) and with them the possibility of asymmetric shocks relative to other EU countries.<sup>42</sup> However, exchange rate considerations seem irrelevant to tackle that problem both because of the high Portuguese wage flexibility and because of the permanent nature of the foreseen shocks (EU enlargement, liberalisation and globalisation).<sup>43</sup> It is therefore important to look at the institutional features that will constrain the capacity of the economy to respond to modernisation and deeper European and world-wide integration.

### **Institutional features of the Portuguese economy**

#### *The labour market*

In Portugal, around 70 per cent of workers are covered by collective bargaining. There are two unions: the above-mentioned UGT and CGTP. The level of bargaining is predominantly sectoral and there is limited coordination between bargaining units. Firm-level bargaining is still very rare while national agreements are attempted each year. Benefit entitlements before tax as a percentage of previous earnings before tax (the so-called gross unemployment benefit replacement rates) are rather high for Portugal: they stand at 65 per cent during the first year and 39 to 43 per cent (if there is a dependent spouse) during the second and third years.<sup>44</sup> Eligibility criteria for unemployment benefits are strict: applicants have to have worked 1.5 years out of the previous two. There is a minimum wage (roughly 318 euros in 2000).

Within this institutional setting, it is noteworthy that the Portuguese experience contrasts with that of Spain. In 1997, after having peaked at 7.3 per cent in 1995, the Portuguese yearly average unemployment rate was 6.8 per cent (in 2000 it fell to about 4 per cent). This rate compared favourably with the other EU member states, in that only Luxembourg (3.6 per cent), the Netherlands (5.5 per cent), Denmark (6.0 per

cent) and Austria (4.4 per cent) reported lower rates just before the launching of EMU (1997). While Portugal and Spain had had a comparable level of unemployment at the end of the 70s (around 8 per cent, higher than an EC average of 5 per cent), in 1997 Spain reported an unemployment rate above 20 per cent.

Both Portugal and Spain have experienced high budget deficits and indeed this fact has contributed, through high interest rates, to the rise of structural unemployment; the same holds, to a lesser extent, for several other factors such as unemployment benefits, institutional factors regarding the way unions work and the deterioration of terms of trade. But in contrast to all other countries, specific effects (unobserved components) are responsible for 40 to 50 per cent of unemployment rates – negatively in the case of Portugal and positively in the case of Spain.<sup>45</sup>

The large weight of the state sector in Portugal first ensured low unemployment in the 1980s, albeit at the expense of raised economic costs in terms of high inflation, while wage increases were then traded for job security, keeping unemployment low. Low unemployment compensation benefits (practically inexistent until 1977) also increased the cost of being out of work.<sup>46</sup> That model, as opposed to Spain's, led to both the lowest wages and the lowest strike rates in the EU. A possible explanation for the fact that Portuguese unemployment did not persist at ever higher levels after the 1980s despite structural adjustment but actually fell, could be what Nancy Bermeo called trading wage increases for job security, given that it was impossible to liberalise dismissal practices in Portugal. Still today, according to the OECD, Portugal (although followed very closely by Spain, and much ahead of other countries) has the highest index of employment protection. But the fact that Portugal had low unemployment benefits and, in practice, rather loose employment protection legislation, may have led also to a higher responsiveness of wages to unemployment.<sup>47</sup> This may have led in turn to a less adverse effect of disinflation on employment and to less unemployment persistence – the explanation stressed by Olivier Blanchard and Juan Jimeno.

Disinflation and structural adjustment in Spain took place three years before the country's accession to the EC, just after the oil price increase and while the labour share still reflected the wage explosion of the 70s. It was of a labour-compensating nature: high wages with high unemployment. Portugal delayed its restructuring until there was an upswing: the oil price was falling, the labour share was already much smaller, privatisation and flexibilisation were becoming effective and transfers and investment associated with EC membership were gaining momentum, in turn opening up (the hope for) employment possibilities.<sup>48</sup>

The timing for stabilisation and structural adjustment may also reflect the fact that there has always been a consensus among political parties and social partners on the pursuit of an active employment policy to ensure social cohesion (although, after accession to the EC, a large part of these programmes were financed by the Community support frameworks). Two episodes during the recessions of 1983/84 and 1993/94 illustrate well this idea: In 1983/84 many workers agreed to work without being paid for several months in order to avoid being on the dole; in 1993/94, in the face of a serious and widespread unemployment threat, the unions immediately accepted lower wage increases. Although it seems that there is no hysteresis in the Portuguese unemployment rate, possible labour mismatch problems should not be ignored as they would indicate that the economy may have entered a more difficult period of employment adjustment.<sup>49</sup> Vítor Gaspar and Sílvia Luz, following Blanchard and Katz (1997) and using quarterly data from 1983 to 1996 to arrive at a wage curve, conclude that there is real wage flexibility even in periods of low inflation and exchange rate stability. Variations in the Portuguese unemployment rate correlate with the cyclical fluctuations of economic activity (Okun's law).

In Portugal wages have been highly elastic with respect both to inflation and unemployment: the wage response (the semi-elasticity) to unemployment has been one of the largest among European countries (only smaller than in Japan and Sweden, in absolute values).<sup>50</sup> Real wage flexibility is a substitute for international labour mobility. Therefore, foregoing exchange rate autonomy seems not to be very costly.<sup>51</sup> De facto flexibility of the labour market, in spite of its rigid regulation, shows that the Portuguese economy has some capacity to adjust to uneven shocks in a monetary union.

#### *Monetary convergence*

New statutes of Banco de Portugal, approved in October 1990, gave the central bank a high degree of economic independence while maintaining an average degree of political independence, as compared with other OECD countries.<sup>52</sup>

By 1995, the statutes of the central bank were amended by Decree-Law 235/95 drawn up by the PSD government but whose ratification in parliament was demanded by the PS after the October 1995 elections at the start of the new political cycle.<sup>53</sup> The ensuing Law 3/96 of 5 February 1996 established the

maintenance of price stability as the primary objective of the Central Bank, taking into account the general economic policy of the Government. The Bank became the sole responsible for the conduct of monetary policy, having the obligation to cooperate with the Government in defining and implementing exchange rate policy. The overdraft facility and direct purchases of Government were officially abolished. In the new law, and as in most European central banks, the Bank retained responsibilities for banking supervision; the Governor was also obliged to inform parliament about monetary policy matters following the publication of the Annual Report of the Bank.

The remaining legal inconsistencies with the TEU and central bank statute requirements<sup>54</sup> were dealt with by the Decree-Law 144/VII, approved in parliament in November 1997, and subsequently transposed into Law 5/98, dated 31 January 1998.<sup>55</sup> Moreover, the Portuguese Constitution, i.e. former Article 105, was revised, eliminating inconsistencies with the TEU. Unfortunately, as mentioned above, there was still cross-party political resistance to enshrine in the constitution the objective of price stability (the constitution refers to the statutes of the central bank).

That resistance is as well a good example of how reactive politics can be completely out of touch with European developments. During the first reading in the revision process, there was even obstruction to the author's proposal to revise Article 105 of the Constitution at all. But fears that Portugal could be left out of EMU's third phase due to a potential inconsistency of the country's fundamental law with the TEU led to an exceptional re-opening of Article 105 already in the second reading of the revision process.<sup>56</sup>

Supposedly in order to maintain the primacy of the Portuguese constitution over the TEU (trying to preserve monetary sovereignty, as if the goal of EMU was not exactly to share monetary sovereignty), the revision of article 105 was accepted provided the new text (which apparently was prepared outside parliament) would not pay too much tribute to the "imported" ideas of price stability and central bank independence.<sup>57</sup> The idea was presumably to eliminate all legal inconsistencies with the TEU as a prerequisite to join EMU without acknowledging its goals (or even understanding them). The PS and, especially, the PSD opposed that the objective of price stability be enshrined in the constitution despite the fact that both parties approved at the same time a parliamentary resolution in favour of monetary union and its objectives. As a result, the new article of the Constitution (now numbered 102) states only that the central bank should act according to the law and the international rules ratified by Portugal(!): it does not specify the Portuguese preferences and is basically redundant. The monetary (like most of the economic) constitution is out of the Fundamental Law. If at all, the new wording of the Portuguese Constitution clearly points to an external constraint rather than to an internal commitment.

#### *Competition policy*

While regulatory reform in the financial sector had already taken place, it is still being implemented in the utilities sector. Public transport companies, television, steel, and chemicals have not yet been restructured. TAP-Air Portugal, the national carrier, features among the most heavily subsidised airlines in the EU, along with Air France and the Greek Olympic Airways. Efforts to improve product market competition included: transcription of EU-directives concerning public procurement policies, financial control over public enterprises by the court of auditors, simplification of the notification procedures for foreign direct investment and more consumer-friendly credit regulations. In 1996 and 1997 further measures were taken to improve the public utility response to consumers and to adopt more consumer-friendly insurance regulations. But, as Barros and Mata already stressed in 1996, while the legal provisions seem satisfactory they have not been properly enforced: there seems to be a generalised bias regarding the interpretation of the principles (concern for the competitiveness of domestic firms and other businesses rights prevail over concern for consumers and social welfare) and decisions are left to several non-independent sectoral supervision bodies and a competition authority that does not rank clearly above the former.<sup>58</sup>

While preparing for EMU, Portugal was among the largest "privatisers" of the OECD<sup>59</sup>: According to the Ministry of Finance<sup>60</sup>, from 1989 to 1999, about 150 selling operations took place including almost 100 enterprises, yielding a revenue equivalent to 25 per cent of GDP. More than half (51 per cent) of that revenue was used for public debt redemption. Until 1995, the biggest chunk of sales (about two thirds of total revenue) was in the banking and industry sectors that had been nationalised in 1975. In 1996, 1997, 1998 and 1999 the privatisation of the remaining shares in some banks and partial privatisation of public utilities (telecommunications and electricity), motorway operating concessions, cement and others, amounted to 2.8, 4.7, 3.9 and 1.5 per cent of GDP, respectively.

#### **Other developments**

##### *Structural funds and sustainable development: a slow change in attitude*

The implementation of the European Single Market directives has greatly contributed to accelerating the

pace (still slow by European standards) of other reforms, as diverse as environmental quality and consumer protection. The total amount of EC transfers in 1996 and 1997 reached 4.3 per cent of GDP (with the structural funds amounting to 3.1 and 3.0 per cent of GDP in 1996 and 1997, respectively, and the cohesion fund reaching 0.2 and 0.4 per cent of GDP in 1996 and 1997, respectively). Net transfers of the EU are of course much lower (below 3 per cent of GDP) and they are expected to continue to fall. <sup>61</sup>Estimates of the impact of the first Community Support Framework (CSF) programme for the period of 1989/93, based on a general equilibrium model, point to an additional GDP growth of 0.4 pp in the short run and 0.5 pp in the long run. The official estimated impact of the second CSF, 1994/99, based on an input-output model, is also a 0.5 pp increase in the rate of growth. <sup>62</sup>

The CSF programme for 1994/99 aimed at reducing the main weaknesses of the Portuguese economy that involve: education, economic infrastructure, the productive structure (characterised by an excessive weight of low-productivity industrial sectors and a very low-productivity agricultural sector), social security, disadvantaged social groups, the environment and regional imbalances. The negotiations of Agenda 2000, concluded during the first half of 1999, have ensured that Portugal will continue to have access to structural funds under the 3rd CFS programme for 2000/6.

Part of the EU transfers have exerted some pressure for internal reform – given that they had to be matched by national public expenditure, they required a definite establishment of long-term priorities in Portugal. It was possible to exert parliamentary pressure on the Government regarding the use of structural and cohesion funds, namely with respect to a better distribution of these funds in favour of the environment. This is even more so due to the NATURE 2000 EU directives which involve some degree of conditionality. <sup>63</sup>

With EMU, the new European co-decision process, the forthcoming enlargement process and the prospect of a closer political union for a limited number of countries within the EU (reinforced cooperation), it is more difficult for Portugal – or it becomes politically much less attractive – to follow the old rule of asking for derogations. Yet, until recently, this was the first instinct of the Portuguese Administration, especially as far as environmental directives were concerned. In the case of the auto-oil programme, the European Affairs Committee of the Portuguese Parliament adopted a resolution project considering that the derogation granted by the EU to Southern countries, “could have had potentially very negative consequences for Portugal, namely with respect to the negotiation of the Agenda 2000”. This meant playing the “European card”: the need not to be perceived as a laggard in the European integration process, especially during an important negotiation of financial resources. The European Affairs Committee that may have a view more similar (long term) to the European Parliament (EP) than most of the other Portuguese parliamentary committees as far as European legislation (increased cooperation) is concerned, can now propose resolutions with respect to the position of the Government in the Council for a number of directives. <sup>64</sup>

Portugal's attitude towards environmental policies and/or a better use of structural funds also relates to its stage of economic development. Although it is true that since 1998 only few politicians, policy-makers and commentators have not come to recognise the advantages of solid monetary institutions and price stability for sustained growth, many do still argue that higher environmental standards (quality convergence), despite being considered a desirable aim in the long run, may impede faster economic growth (real convergence). As in the case of EMU, the political consensus on the priority of higher standards on environmental quality, consumer protection and internal social cohesion, all pre-conditions for long-term development, over the mere access to EU funds is taking long to build. <sup>65</sup>

#### *Pre-euro exchange rate developments*

The escudo was forced to devalue several times during the ERM crisis. Because the financial markets had been associating the escudo with the peseta, the authorities followed an intentional policy of de-linking the two currencies from the start of the period of turmoil. This policy was relatively successful (as shown by the reduction of daily exchange rate volatility and of the need for official intervention in the foreign exchange markets). Interest rates on 10-year government bonds fell 300 basis points in the following 12 months.

In nominal effective terms, the escudo has behaved in a fairly stable way since it joined the ERM in April 1992. Until 1997, the behaviour of the escudo against a basket comprising the currencies of 26 industrialised countries (BIS data) was one of the most stable of all EU currencies. In real effective terms (using the CPI as a deflator), the Portuguese escudo from the time of joining the ERM roughly until its exchange rate was locked into the new EMU grid in 1998, was by far the most stable currency in the EU: its real effective exchange rate appreciated by less than 1 per cent until the end 1996. Since 1987, it appreciated 27.2 per cent, more than any other EU currency. This is because from 1989 to 1991 there was

a substantial rise of unit labour costs. However, it was only in 1997 that the effects of exchange rate stability became apparent on the reduction of capital costs, which in turn contributed to economic recovery.

#### *Fulfilling the convergence programme and the stability pact*

Contrary to most EU countries, no special measures were taken in Portugal (on the expenditure side) to reduce the budget deficit to 2.5 and 2.2 per cent of GDP in 1997 and 1998, respectively. Although falling for the third consecutive year, the level of the public debt was still excessive in 1997<sup>66</sup>, around 61.5 per cent of GDP<sup>67</sup>; only in 1998 it fell to 57.8 per cent of GDP. In fact, government current spending depends basically on the public sector wage bill that grew more in 1997 and in 1998 than in most other EU countries. In the period 1995-99 fiscal consolidation was achieved largely through higher tax returns due to stronger economic growth and tougher tax enforcement. The danger of slippage comes in the short run from the possibility of deficient expenditure control, namely in regard to health. That happened in 1997 and in 1999. In 1997 higher tax returns and both tax enforcement and lower than expected expenditures on social security maintained the deficit ratio below the target; however, in 1999 that slippage was reflected in the stock of public debt in 1999 (which decrease only to 56.8 per cent of GDP<sup>68</sup>) and 2000 (which is expected to augment to 57.1 per cent of GDP).

Portugal did not make a big effort to reduce the deficit and the debt: the general government primary balance reached a level of 4.2 per cent of GDP in 1992 but remained quite small thereafter, amounting to only 1.7 per cent of GDP in 1997 and 1.1 per cent of GDP in 1998 (it is expected to remain below 3 per cent until 2004); contrary to what happened in all other EU members, non-interest expenditures grew (more than in any other EU country) between 1993 and 1998 and there was a dramatic fall in the implicit interest rates on public debt and a reduction in interest payments from 1991 to 1998.

The compliance with the Stability Pact hinges on the capacity to increase the primary surplus from 2000 onwards. For 2000 the budgeted deficit amounts to 1.5 per cent of GDP, and the public debt is expected to increase to 57.1 per cent of GDP, while these values are set to converge in the following years to 0.0 and 48.4, respectively, in 2004, in the Stability Pact.<sup>69</sup> Cutting current public spending would increase confidence and reduce the growth-adjusted effective interest rate, but pressure to increase taxes tends to have the opposite effect.

In addition, the speed of debt reduction will be determined by the receipts from privatisation and pension expenditures. While there is still some scope for privatisation in 2000/2001, in the longer term, fiscal sustainability depends on the capacity to restructure the social security system whose deficit can reach 8.5 per cent of GDP in 2035 according to OECD simulations.<sup>70</sup>

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<sup>1</sup> Earlier versions of this paper were presented in Ponta Delgada at the Universidade dos Açores, in Zagreb at the European Integration Forum, in Brasília at the occasion of the Economic Session of the Congress Brasil-Portugal 2000, in Lisbon at the ISG, the ISCTE, the CIJD and the Diplomatic Institute, and in Budapest at the University of Economic Sciences. I wish to thank discussants and seminar participants for useful comments.

<sup>2</sup> The importance of that decision has only been recognised by the main political forces *a posteriori*.

<sup>3</sup> See Torres (1989 and 1990) for a presentation of this argument as a policy proposal. See also Torres (1996 and 1997) for a more thorough discussion.

<sup>4</sup> See also Torres (1998a).

<sup>5</sup> See Torres, 1989 and 1990.

<sup>6</sup> See Torres, 1996, for a discussion. Other arguments, for the case of low inflation countries in the context of EMU, are provided by Eichengreen and Gironi (1996).

<sup>7</sup> See Torres, 2000.

<sup>8</sup> For a thorough analysis of these issues see Torres and Giavazzi (1993), namely the synthesis of Casella (1993).

<sup>9</sup> As Willem Buiter (1996) put it, real convergence or divergence had nothing to do with EMU. Examples for other EU-countries can be found in Buiter (1996) and Jones, Frieden and Torres (1998).

<sup>10</sup> Unfortunately, these policies are still quite popular. For instance Portugal tends to opt for lower energy costs (wrong incentives to pollute more) in the name of short-term competitiveness.

<sup>11</sup> Depending on the perspective: the only way of tying Germany into the European Union, achieving more political integration, accomplishing faster enlargement to the East or, simply, maintaining access to the structural funds.

<sup>12</sup> Unfortunately, some still see it as an unavoidable external constraint that goes together with an exogenous political objective to which their political leaders have converged. A good example, discussed below, was the cross-party political resistance to enshrine in the Portuguese constitution the objective of price stability.

<sup>13</sup> See Macedo and Torres, 1991, and Torres, 1991.

<sup>14</sup> See Cadilhe, 1990.

<sup>15</sup> In any case, in 1989, the case for a European single currency was not perceived at all as a central question for Portugal. Both the Government and, especially, the monetary authorities were lagging behind European developments.

<sup>16</sup> See Ministry of Finance, 1992.

<sup>17</sup> Textile and clothing (with productivity levels at two thirds and one half of the Portuguese manufacturing average in 1989) experienced an initial rapid expansion with free access to the EC market but world-wide competition, fragmentation, lack of marketing and higher domestic interest rates (due to the policy of capital controls pursued in 1990 and 1991) accelerated those calls.

<sup>18</sup> This was clearly recognised by the then prime minister, Aníbal Cavaco Silva, who stated that some segments of the administration had difficulties in digesting the new monetary regime (Silva, 1994, p. 512).

<sup>19</sup> Interest payments on the debt fell from 8.6 per cent of GDP in 1991 to 7.8 in 1992, 6.8 in 1993, 4.8 in 1996 and 4.2 in 1997. Meanwhile, the official inflation target set in the convergence programme was met in 1992 and 1993 and in the four subsequent years, fulfilling the Maastricht criterion in 1997.

<sup>20</sup> See Torres, 1998b.

<sup>21</sup> See Torres, 1995.

<sup>22</sup> See Macedo (1996) for an analysis of different episodes of currency (in)convertibility in Portugal

<sup>23</sup> After several statements made by the Prime Minister reaffirming his commitment to that objective, the consensus on the goal of Portugal's participation in the core group of countries moving ahead to the Third Phase of EMU was established in Parliament during the first debate of 1996/97 on the single currency. Both in the PS

and in the PSD, and especially outside party circles, some sectors remained unsatisfied with such a convergence of views. Within the PSD, that convergence had already been contested in October 1996 at the occasion of a special congress.

<sup>24</sup> The PSD remained divided over that consensus. Those against, especially people with responsibilities for economic policy, had already opposed (some less openly but with quite disruptive aims) from within the party and the government, the European monetary integration strategy led by the former Minister of Finance Jorge Braga de Macedo.

<sup>25</sup> See proceedings of the Economic and Financial Parliamentary Committee hearing of April 4, 1990 (CEF, 1990).

<sup>26</sup> Not to mention the special case of Finland described for instance in Moses, 1997.

<sup>27</sup> By 1997 concerns voiced by the Portuguese banking association turned to the financial set-up costs involved in replacing the national currency by the Euro, given the importance of currency exchange trading for the banking activity. In a hearing in the parliamentary committee on European Affairs (see CAE, 1998), however, two private bankers dismissed the importance of such costs. The issue was dead although, after the inception of EMU, Portuguese banks went on charging very high fees for cross-border transfers (euro 25.13 in Portugal as compared with euro 8.15 in Luxembourg) and other payments, as well as practising the so-called double charging, forbidden by the Cross-Frontier Transfers Directive (97/5), in the Euro zone (IEIC, 2000).

<sup>28</sup> Some commentators were busy, between 1995 and 1997, announcing the end of the entire EMU project on occasions as different as the Spanish lorry-drivers strikes, social security reform plans in France, reports on German unemployment and so on.

<sup>29</sup> At present this is the case for “real versus environmental convergence”. See Torres, 2000c.

<sup>30</sup> Anti-EMU positions and “anti-European ideologies” could be observed in all party circles and many different fora dominated by both right wing conservatives and traditional leftists, who had in common their distrust of the then on-going European integration process. To some extent (with somehow different actors) that situation was repeated during the Kosovo crisis in 1999.

<sup>31</sup> That notion, named “positive variable geometry”, put forward by the author in a hearing of the Committee on European Affairs of the Portuguese parliament in May 1994 (see CAE, 1994), was adopted in a parliamentary resolution on the principles for the revision of the Treaty on European Union in April 1995. The concept of flexible integration, contained in the Amsterdam Treaty, is applicable to other domains of European integration. See also Dewatripont et al. (1995) for a more elaborated proposal, featuring a set of mandatory competencies, the common base, and allowing for deeper forms of cooperation, open partnerships.

<sup>32</sup> See Kavanagh et al., 1997.

<sup>33</sup> See Torres, 1998b.

<sup>34</sup> Until 1997 the PCP and the CDS-PP were opposed to any external liberalisation of the economy and to further European integration. When it became clear that Portugal would participate in EMU from its inception this position softened.

<sup>35</sup> Ministry of Finance, 1993.

<sup>36</sup> Ministry of Planning, 1996.

<sup>37</sup> At the same time, early participation in EMU was attacked on the grounds that Portugal should participate in an EMS II with the other Southern European countries. This position also changed dramatically just before the Italian Prime Minister Romano Prodi asked for a slower pace in the transition to EMU. Portugal decided then to de-link from any ambiguous positions concerning the process of monetary integration in order not to provide any reasons to be excluded from the first tier in EMU.

<sup>38</sup> Up to 1994; See Gros and Vandille, 1995.

<sup>39</sup> The Internal Market seems not to have increased sectoral specialisation in Europe but, on the contrary, has led to specialisation in different quality/price ranges within the same sectors, as seems to be also the case for Portugal in recent years.

<sup>40</sup> OECD, 1996.

<sup>41</sup> That concentration led to the exclusion of the region "Lisbon and the Tagus Valley" from objective 1, in terms of structural funds in the new financial package for 2000-2006.

<sup>42</sup> Besides, business cycles tend to be more highly correlated in integrated countries, hence the potential need for unilateral policies such as exchange rate devaluations is reduced.

<sup>43</sup> In any event, exchange rate flexibility can only have a transitory impact on the economy and hence does not dispense the need for long-run real adjustment of a country's economic structure. Moreover, nominal exchange rate devaluations are totally ineffective if they cannot affect relative prices.

<sup>44</sup> Data refer to 1995; see Martin, 1996.

<sup>45</sup> See Scarpetta, 1996.

<sup>46</sup> The average replacement ratio of the OECD was 34 per cent in 1995, 25 per cent in the period from 1987 to 1991, 7 per cent in the period from 1979 to 1985 and 1 per cent in the period from 1973 to 1977 (Blanchard and Jimeno, 1995).

<sup>47</sup> Small firms tend to circumvent regulations by not paying social security contributions and by relying on short-term contracts. Also, a significant number of workers with permanent contracts were laid off during the recession of 1993/94, suggesting that there is a *de facto* flexibility in the labour market (OECD, 1996).

<sup>48</sup> Sacrifice ratios (the number of percentage points between real production and equilibrium production for each point less in the inflation rate) confirms that view for the period 1980-94 as a whole: Italy and Portugal have ratios of 0.65 and 0.66, respectively, while Ireland and Spain have ratios of 1.0 and 1.47, respectively. See Barbosa and Machado (1996).

<sup>49</sup> See OECD, 1996, for a description.

<sup>50</sup> See, among others, OECD (1992) and Luz and Pinheiro (1994). According to some studies reported in Gaspar and Luz (1997) also in the Netherlands wages are highly elastic to unemployment (-0.17), in absolute terms slightly above the value for Portugal (-0.16). Increasing wage bill differentials (see OECD, 1996) also suggest high nominal and real wage flexibility. On the other hand, the rate of structural unemployment has scarcely changed since the beginning of the 1980s.

<sup>51</sup> This is true even if one rejects money neutrality and takes the view that discretionary exchange rate policy can affect output.

<sup>52</sup> See Torres (1998b) for a discussion on Portugal and Grilli, Masciandaro and Tabellini (1991) for the criteria of political and economic independence.

<sup>53</sup> This initiative, welcomed by the author in parliament in the name of PSD, was obviously opposed by those within the same party and group that also contested any mention to central bank accountability in the parliamentary resolution in favour of a monetary union in Europe, the approval of the 1997 and 1998 budgets and, of course, ERM membership and exchange rate convertibility in 1992.

<sup>54</sup> See CEC, 1996; EMI, 1996.

<sup>55</sup> The Governor of the Central Bank had discussed, at the parliamentary Subcommittee on Economic and

Monetary Union, all these inconsistencies and the necessary changes contained in the Decree Law presented to Parliament by the Government. The proceedings of those meetings and the report on the Decree Law can be found in CAE (1998).

<sup>56</sup> See Torres, 1998b.

<sup>57</sup> See DAR, 1997.

<sup>58</sup> The first Competition law dates from 1983 and was revised in 1993 (Decree-Law 371/93).

<sup>59</sup> OECD, 1996.

<sup>60</sup> See Ministry of Finance, 2000b.

<sup>61</sup> This is because the bulk of EU expenditure is related to the Common Agricultural Policy. Given the structure of the agricultural sector, Portugal is reported to be a net contributor to the EU in this sector.

<sup>62</sup> See Gaspar and Pereira (1995) for the general equilibrium model and Ministry of Planning (1993) for the input-output model.

<sup>63</sup> See Torres, 2000c.

<sup>64</sup> Examples of potential cooperation between national parliaments and the EP, not only in this field but also as far as political accountability for monetary policy and general economic policy guidelines is concerned, were to be discussed at the COSAC meetings in Lisbon held at the end of May 2000. The author was nominated *rapporteur* by the European Affairs Committee and prepared a questionnaire for the effect that, most regrettably, was essentially ignored and partly scattered into a wider pre-existent questionnaire of the responsibility of the staff with no relevance whatsoever for this topic. Neither explanations nor justifications were given for that conscious boycott.

<sup>65</sup> While there are clear signs of a positive change in attitude from the part of the new Minister for the Environment together with increased pressure from both the Portuguese NGOs and the European Commission, the political debate still centres (with the exception of some attempted cooperation with the EP, most of the time boycotted by political parties) on issues such as who has built more kilometres of motorways and bridges or, demagogically, on refusing locally (“not in my backyard” considerations) any global solutions.

<sup>66</sup> The TEU stated however that the debt ratio could be exceeded in exceptional circumstances, namely if diminishing sufficiently and approaching the reference value at a satisfactory pace, which was the case.

<sup>67</sup> According to the new European System of Accounts implemented in 1999, ESA 95 (Council Regulation 2223/96 of 25 June 1996), the public debt ratio for 1997 turn out to be 60.3 and not 61.7.

<sup>68</sup> According to the ESA 95 methodology, there was even a slight increase of that ratio from 56.5 in 1998 to 56.8 in 1999.

<sup>69</sup> Ministry of Finance, 2000a.

<sup>70</sup> OECD, 1996